UK MARKET VIEW

OUTLOOK IMPROVES BUT TENDER PRICES STILL EXPECTED TO FALL

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As we approach the end of the first quarter of 2021, the combination of increasing input prices and improving market sentiment are having an upward impact on our market forecasts.

While conditions remain challenging, the current 'lull' in pipeline is not expected to last and construction output will increase as the impact of government investment plans starts filtering through to the market. The repurposing and reconfiguration of commercial and retail space is also likely to see a significant shift in activity, and the question is how the industry will react to a potential surge in demand, as concerns linger about the longer lasting impact on input prices and labour availability in a post-Covid-and-Brexit UK market.

	2020	2021	2022	2023	2024
National	0.0%	-1.0%	0.5%	1.0%	2.0%
London	0.0%	-0.5%	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.

Construction may have recovered faster than the wider economy, but due to the substantial drop-off in the spring, overall it had a worse year. Whereas GDP declined...

9.9%

output in the industry fell...

12.5%

New orders were...

8.8%

smaller than in Q3, pointing to a suppressed pipeline moving into the new year

A small drop in December meant construction output ended the year...

3.5%

smaller than before the pandemic.

Material prices were rising rapidly at the end of last year, increasing...

3.2%

in the final quarter.

SETTING THE SCENE

In our first report of the year, and largely due to the success of the vaccine roll-out, we have revised up our forecasts for tender prices in 2021. While conditions will remain challenging, especially in the first half, prospects have significantly improved and, as such, we are less downbeat than before. In addition, input costs are rising at a much faster rate than when we prepared the Q4 report, limiting the potential for cuts. Notably, material prices rose at a record 3.2% in the final quarter, with much larger increases for steel and timber products.

The wider economy's performance this year will largely depend on the speed with which restrictions are lifted. On this front, things are going about as well as possible, raising hopes that the second half of the year will be a strong one. A glut of savings and substantial pent-up demand from people having spent the best part of a year hiding away forced to stay indoors creates the potential for a huge increase in spending. Risks also exist. At some stage the furlough scheme will come to an end, at which point unemployment, already steadily rising, could spike. Similarly, there are many firms currently reliant on government support who may come into difficulty once it is no longer available. It is also evident that Brexit is having a significant impact on some industries, notably fishing, and damaging some trade. From July, at the end of the grace period, imports will require new customs declarations, adding further friction to trade and potentially pushing up costs.

For construction, we already have a good idea how the early part of the year will develop based on new orders figures. Unfortunately, these finished the year in disappointing fashion. Rather than reversing some of the year's earlier losses, there was a steep decline in Q4, with the commercial sector once again suffering the most. Despite adopting a more positive mindset in our latest analysis, we cannot hide away from these numbers and their implications. Sentiment may not be as low as it has been, but only once a stronger pipeline emerges across the board, will tender prices start to ramp up.

Last year was one of drastically varying performance between the different sectors. Within new work, infrastructure was the stand-out category. Not only did it see the smallest decline during the spring, but it was the only sector where output was higher in December than February. Elsewhere, housing suffered the largest drop but a strong recovery, whereas private commercial regained ground at a much slower rate. This makes finalising our 2020 tender price changes somewhat tricky and it is almost certain there will be much wider variation than usual, depending on the contractors and projects involved. Overall, we believe that they will have been approximately flat.

Looking further ahead, there is the potential for the construction industry to enjoy a huge increase in output. Having got 'Brexit done', the government has moved onto its next three-word slogan of 'Building Back Better'. Construction looks set to be at the heart of this revival, delivering the new hospitals, schools and infrastructure schemes promised. Similarly, the UK does not build enough houses and the government continues to target a large expansion in this sector. However, there are questions about whether the industry has the capacity to complete all of these projects, and a large increase in inflation may be an unfortunate side effect. New data also raises doubts about the size of the workforce and whether it can meet expectations. For the time being, we believe it too early to be changing our forecasts, but we discuss both factors in detail below so as to highlight some of the upside risks.

THE PAST:

WHY, ON AVERAGE, TENDER PRICES WERE UNCHANGED IN 2020

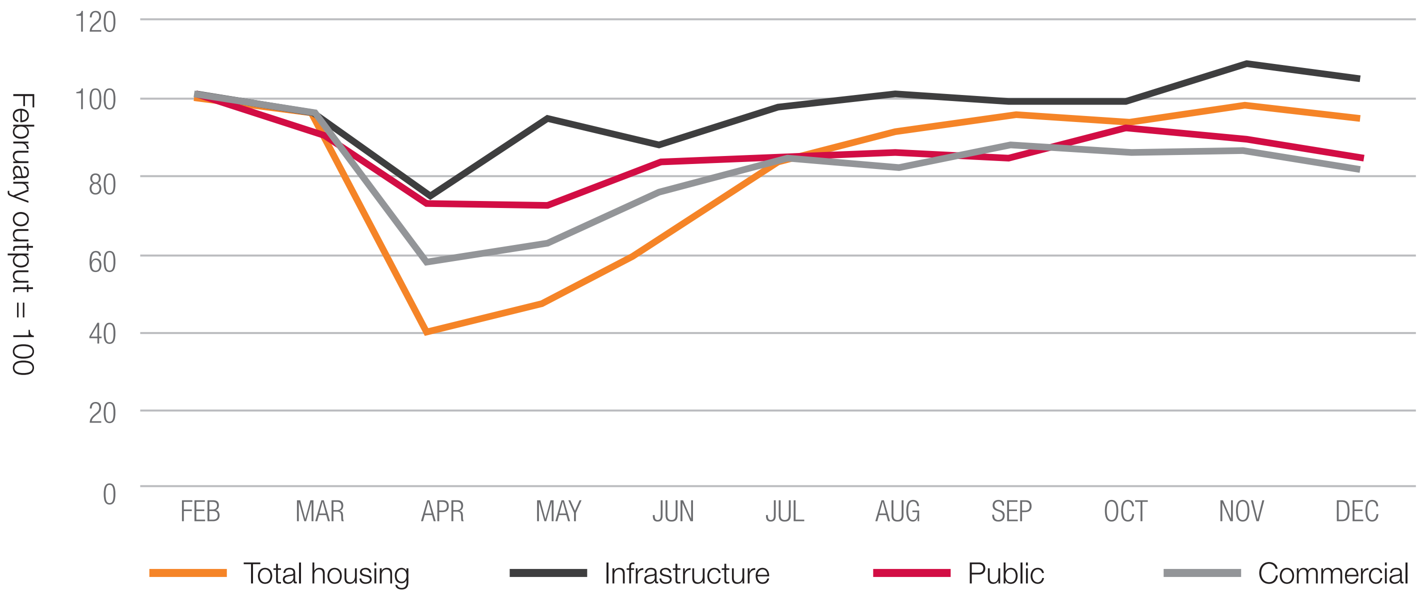
Output

Starting off with the bad news, construction output fell 12.5% in 2020. All sectors experienced a year-on-year decline, with housing the worst hit and infrastructure the least. Construction's monthly data tends to be fairly volatile, particularly when drilling down to the sector level and last year saw incredibly wild swings. Housing may have made a stronger recovery than many other sectors, but its dramatic decline in the spring meant, for the year as a whole, it fared worst. From February to April, housing output dropped 60%, with developers unsure how they could sell newly completed properties. However, with a cut in stamp duty and many people saving more than usual, the reopening of the residential market and allowance of estate agents to continue operating triggered a resurgence in the sector. As a result, December's level of housing output was only 5% lower than in February.

While looking at the entirety of last year is important, comparing the final few months with the start, give us the clearest indication of travel. This is most evident in the commercial sector. It may not have had the most severe drop when construction sites closed, but its recovery has been poor, and it remains almost 20% below February's level. This weakness may partly be due to social distancing measures having a greater effect than for other types of project. By contrast, infrastructure which is more likely to be outdoors with larger working spaces is now back above pre-pandemic levels. In total, this sector shrunk just 3.9% in 2020 and the outlook for 2021 looks strong.

The sector finishing the year in the best position relative to February was repair and maintenance in private housing. Not having to commute and rarely going out, alongside spending most of their time at home, has motivated many to make home improvements, leading to a large expansion in the sector. Tighter restrictions at the end of the year and a possible reluctance to let builders into the home meant output fell in November and December but, before that, growth had been rapid. The sector's performance may not have a direct link to tender prices given big contractors don't get involved in renovating individual houses, but it can affect them in other ways, especially through material prices. The total repair and maintenance sector accounts for just over a third of construction output, with private housing making up a substantial chunk of this. As such, the increase in demand for materials from repair and maintenance will have fed through to the wider sector.

HOW OUTPUT HAS RECOVERED



Materials

By the end of 2020, construction material prices were shooting up. Following an unprecedented final quarter, the 'all work construction material price index' finished the year 4.6% higher than in December 2019. Somewhat remarkably, as recently as September, prices were lower than 12 months previous, highlighting just how significant a spike there has been for this turnaround. While there are several factors which caused this change, not all of them are unique to construction. With neither consumer nor producer prices having seen such a surge in inflation it is difficult to fully justify why material price inflation is so much higher than other indicators.

That Covid and Brexit created the two main problems facing purchasers of all types of products, not only construction materials, should hardly come as a shock. With concerns about a no deal only fully allayed in the final weeks of December and businesses not knowing how the new year would start, stockpiling was once again on the agenda. In order to prevent the risk of facing delays due to material shortages, firms increased their inventories to higher levels than usual. March 2019, when this happened before, saw a quarterly inflation rate of 1.7% and also marked that year's highest level of the index. While a repeat of prices falling in the coming months seems doubtful, it does provide a good example of the impact stockpiling can have and what happens as stocks are drawn down. Further complicating matters are issues with shipping costs as a result of Covid. With global trade and manufacturing essentially shutting in the spring, this has led to ships being out of place, a shortage of containers, and a resultant substantial increase in costs.

More specific to construction are a number of key materials experiencing rampant growth. Steel prices have risen because of demand, rising much faster than supply, partly due to weaknesses in iron ore production. Global demand outpacing supply is also affecting timber products. Domestically, surveys continue to report on plaster price increases as the manufacturing shutdown earlier in 2020 appears to still be having an effect. Finally, and likely underpinning all these other contributory issues, the construction sector's recovery has been especially good. This is especially the case for private housing repair and maintenance which is one reason builder's merchants' revenues rebounded in the second half of last year. Travis Perkins' end of year results show this best and, while its merchanting arm saw sales decline in both halves of 2020, the retail part of the group saw strong growth and, as a result, revenue was up for the full year. Despite some manufacturing closures, the main reason for inventory difficulties was high demand and this continues to push prices higher. However, while conditions remain tough, stocks for many products are steadily increasing, and price pressures should ease as the year progresses.

Labour costs

Were we to plot average weekly construction earnings in 2020 on a graph, it would have a similar trajectory to that of housing output; specifically, a large reduction in the spring followed by a fairly swift recovery. From the end of 2019 to May, pay had fallen almost 10%. There are likely to be two main reasons why there was such a large drop-off, both which were temporary and should therefore not have had a significant impact on last year's tender prices. Firstly, many contractors reacted to having to shut sites and facing a collapse in revenue by asking staff to take a cut to their pay. Secondly, without the need for workers on site, many employers placed their staff on furlough. While in April over 40% of construction employees were on furlough, this had come down to under 4% at the start of this year. Furloughed employees may have only received 80% of their usual pay, but as they returned to work this would have also reverted back. That 17% of the workforce across all sectors were still furloughed in early January, again shows the strength of construction's recovery.

When bidding for work, neither temporary pay cuts nor staff on furlough should have materially altered a contractor's view on price. Both are short-term issues, with furloughed staff by definition not contributing to a project. Where contractors may have viewed labour costs as offering some savings is the belief job losses in the industry would lead to greater bargaining power. Between Q2 and Q3, the size of the workforce shrunk by 100,000 people, about, 4.5%, but with both vacancies and output having fully recovered, it suggests only limited ability to cut costs.

Preliminaries, margins and a willingness to accept lower turnover

With such volatile movements, correctly calculating the total cost of a job has become even harder than usual. In addition, firms have had to manage sites closing and reopening, staff absences and the costs involved with social distancing and other health measures. Mace regularly surveys its subcontractors and, towards the end of last year, some were reporting that either they themselves were cutting tenders or they were seeing competitors do so. Facing a more competitive market, some firms were choosing to accept lower margins in order to win work. Different behaviour would depend on the package, an individual firm's pipeline and their keenness to maintain to workload. Some contractors may be more willing to accept lower turnover and similar levels of profitability. By sitting tight, they may feel better placed if there is a more substantial recovery this year.

THE PRESENT:

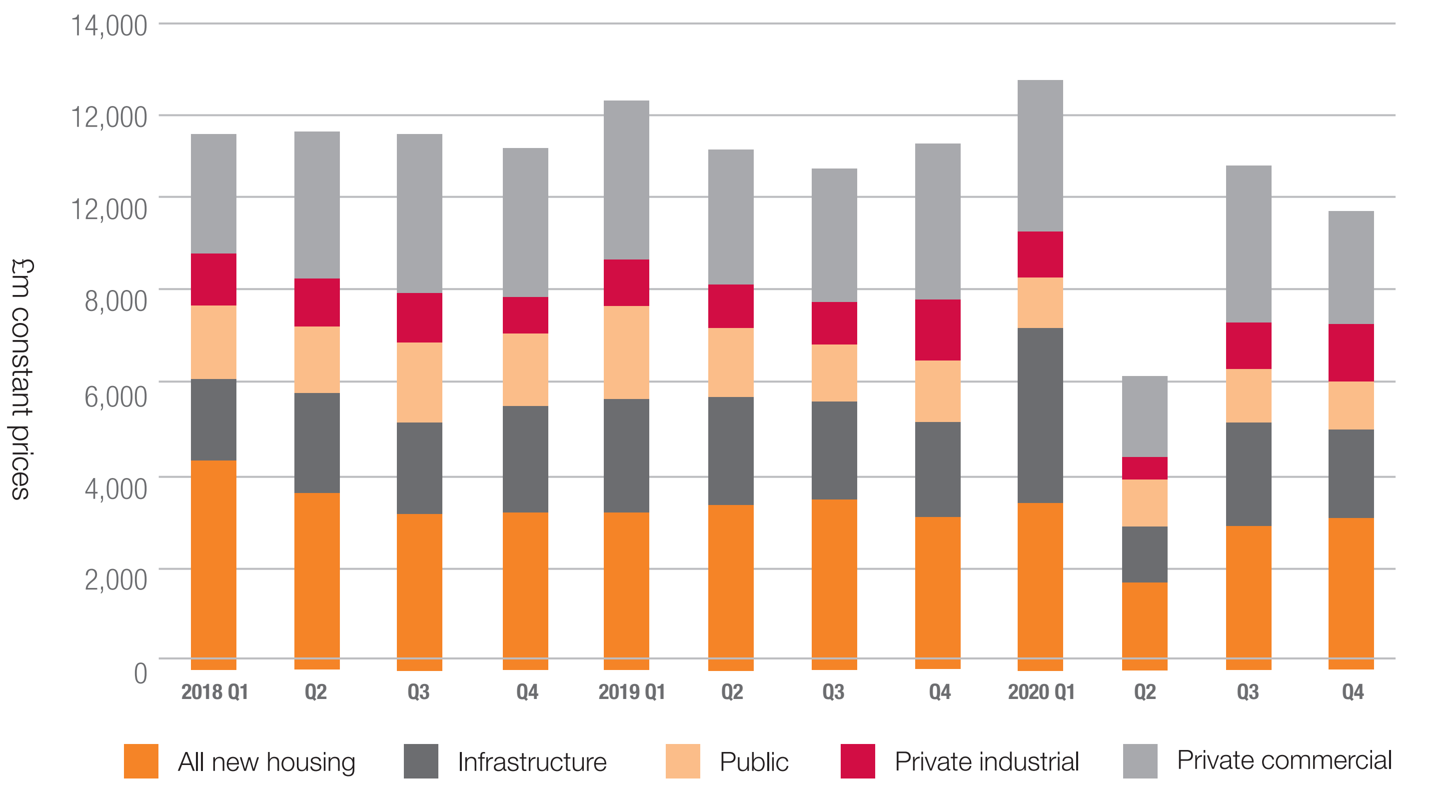
SUPPRESSED PIPELINE AND NEW RULES MAKE A DAMAGING MIX

New orders

Despite output making an almost complete recovery, it is difficult to imagine much more upside potential without an improving pipeline. Unfortunately, the latest new orders data show this isn't happening. As with most economic data, there was a sharp drop in the second quarter with the country in standstill. In Q3, new orders bounced back to a respectable level, slightly below the 2019 average. This gave some hope there would be a release in pent-up demand and a catch-up on projects put on hold, but the latest data dashes this notion.

Between the third and fourth quarter, new orders declined 13% and, excluding the dismal Q2 figures, this was the worst quarter since 2012. For 2020 as a whole, new orders were 13% lower than 2019, giving a good indication of just how much less may come onstream this year. Obviously, output for the entirety of 2021 will be much higher than last year because there was such a large drop-off during the spring and summer. Yet the latest data makes it difficult to believe it will beat 2019's level, particularly in some sectors. Private commercial may not have seen the largest drop-off in new orders, but is probably the sector facing the most fundamental difficulties. Overall, commercial new orders were down 14% on the year with a particularly sizeable drop in the final quarter. Entertainment was the primary reason for the decline, perhaps not surprising given restaurants, clubs and bars spent most of the year shut. Interestingly, the offices portion of this sector was almost unchanged in 2020 compared to the previous year. Whether this resilience can continue going forward, with new hybrid ways of working set to become the norm for many, remains to be seen. As a good example, HSBC is planning on cutting its global office space by 40%. In London, over the next few years this will involve more people working from their Canary Wharf headquarters with leases on other offices around the city not renewed. While some banks have been more vocal on expecting workers to return, it is likely demand for new office buildings will fall.

NEW ORDERS CONTINUE TO STRUGGLE



Worryingly, the worst performing sector in 2020 was the non-housing public sector. Here there was an almost 30% year-on-year drop, largely due to schools and colleges. In nominal terms, new orders declined from £3.3 billion in 2019 to £2.2 billion last year. While there was growth in the health sector, this was nowhere near enough to make-up the gap. A string of government announcements suggests education's decline should be temporary and, with it accounting for around 40% of the sector, these announcements coming to fruition will help to bring a degree of normality. Infrastructure and public housing were the only two sectors to see an increase in new orders in 2020. Importantly, given the size of the private housing sector, while new orders fell considerably last year, the final quarter was more promising and saw a further rebound following the almost 70% jump in Q3.

Risks and regulations

There are also a myriad of other issues clients that contractors and consultants need to be aware of. On their own, none of them are unmanageable, but combined they may push up overheads and risk allowances. In our last report we discussed the risks of insolvency, and conditions have since deteriorated. Whereas at the end of September, 28% of construction businesses reported the coronavirus as having increased the risk of insolvency, by the middle of January this had increased to 44%. Similarly, the proportion of firms who believed they were at high or moderate risk of insolvency had risen from 11% to 17%. More positively, this time no firms were in the high risk category. The need for good due diligence and a strong understanding of the supply chain is more important than ever in the current market.

It is also easy to imagine failing firms becoming increasingly litigious. More fundamentally, sites shutting down has had an inevitable impact on programmes, and while we would hope most projects will involve amicable relationships, this will not always be the case. Becoming embroiled in a dispute, costs time and money, and could feed into tender costs. Adding to the industry's woes are issues around insurance premiums. These have increased substantially after the Grenfell Tower Fire and with insurance companies facing their own difficulties due to Covid, will only rise further.

On top of all of this, and putting more stress on the sector, are changing government regulations. From the start of March, customers will have to pay the VAT charge rather than suppliers. Most importantly, contractors will now pay HMRC directly rather than the sub-contractor, who then pays the tax. Known as the VAT reverse charge, its introduction is aimed at preventing fraud, but one of its side effects is it will reduce cash flow. Another amendment is around the employment of off-payroll working. Coming into effect in April, IR35 will change the tax status of many freelancers, meaning they should be treated as employees rather than self-employed. As an industry, construction has more than its fair share of self-employed workers and many are likely to find they fall under the new tax regime. While in theory neither of these changes should particularly affect tender prices, they may take time to adapt to and cause new frictions in an already fractured system.

Finally, with the government's focus on 'Building Back Better', it is introducing a variety of changes which construction firms will have to understand in order to win new public projects. In December, the government published its new Construction Playbook and also a Green Paper on Transforming public procurement. The Playbook in particular contains many policies which are now mandatory. These include sections on supply chain involvement, digital technologies and risk allocation. Both papers also mention the importance of the UK reaching its net zero carbon target by 2050. At the moment, while pursuing lower emissions is undoubtedly the correct thing to do, it will often involve higher costs. As technologies improve, this should change. But, for the time being, clients may have to accept higher tender prices in order to achieve their green goals.

THE FUTURE:

POTENTIAL FOR MOUNTING INFLATIONARY PRESSURE

Demand rising

In the medium term, the government has ambitious plans to rebuild the economy. However, delivering all of these schemes, let alone on time and to budget, is likely to put the construction industry under intense pressure. Infrastructure is the sector which will drive growth over the next five years, and many of the largest projects are already well underway. In particular, HS2 and Hinkley Point C are two of the biggest projects ever undertaken in this country. Crossrail, a project which should have finished several years ago, but remains ongoing, provides a cautionary tale. There were a number of press reports near the time of its supposed completion that its demand for trades was clashing with similar requirements for the building of Tottenham Hotspurs' new stadium, driving up pay. There is similar anecdotal evidence around the pay for a variety of trades in the South West over the past few years due to Hinkley Point C. In addition to workers potentially being able to push up their pay if they find themselves in demand, contractors who have strong pipelines will be in a better position when it comes to tendering.

Were it just large infrastructure projects, we might expect to see isolated pockets of this sort of inflation. However, in addition, the government is promising 40 new hospitals and a wave of new schools. Following a burst of spending immediately after the global financial crisis as the then Labour government tried to boost the economy, construction output in the non-housing public sector has shrunk noticeably; in 2019, it was 40% smaller than 2010. During this period, the size of the over-75s has increased 16% and it is estimated it will increase another quarter over the next ten years. Providing the necessary facilities for an aging population will therefore require a large uplift in spending.

Housing is another sector where the industry may find demands greater than capacity. Completions in 2019 numbered 175,000 in England, and a long way short of the government's goal of 300,000. Given the residential sector is by far the largest part of the industry, even a 10% increase would have a significant impact and almost certainly affect tender prices. Further to the need for new houses, issues around cladding are unresolved and many buildings still require remedial works. As there is an urgent need to fix this issue, sensitivities around cost may be weaker than usual, which could also contribute to an inflationary environment.

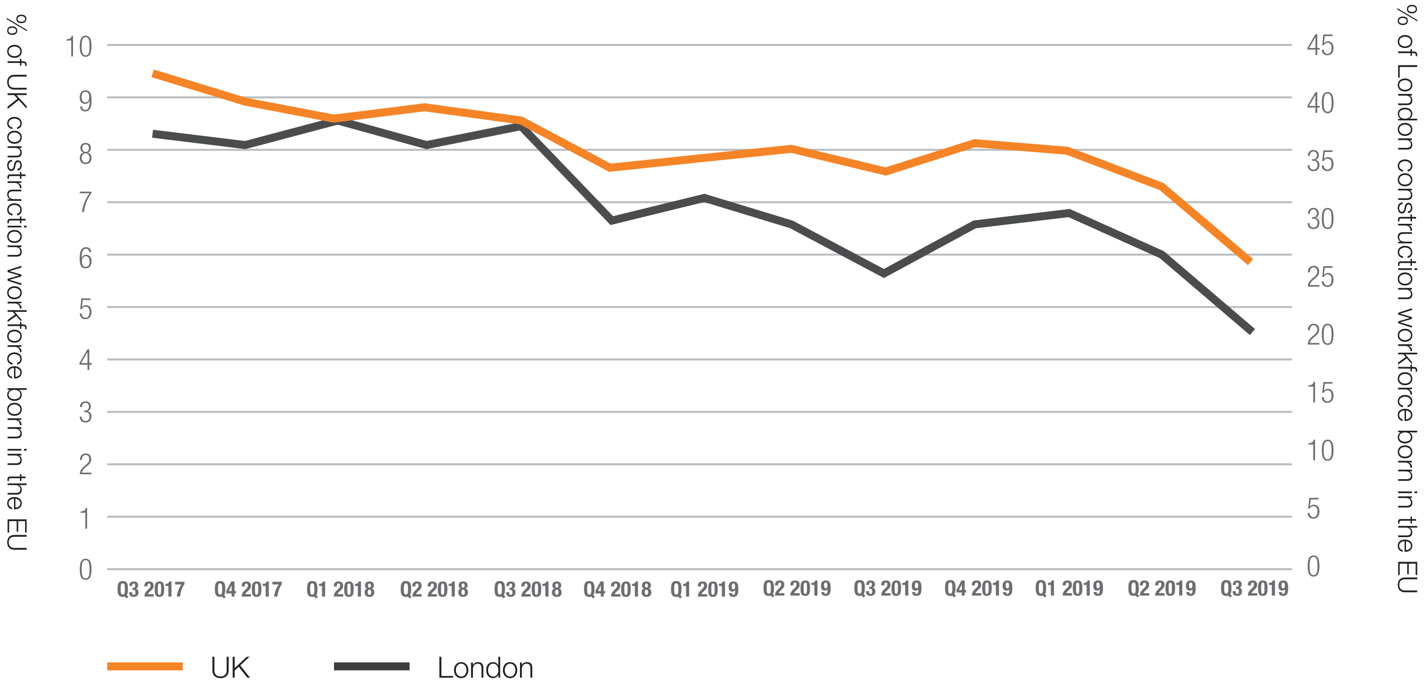
It is quite easy to make the case that much of this growth will not materialise. Proposing policies is much easier than delivering them with the recent new orders and output numbers pointing to a weak public sector. More fundamentally, government borrowing has rocketed during the pandemic and there will be plenty of calls for belt-tightening and renewed austerity. For the moment, it is too early to say we will see the sort of fiscal expansionary approach required for sustained increases in tender prices.

Workforce problems

A second issue that may lead to much higher tender prices than currently anticipated relates to a shrinking workforce. The industry has constantly talked about skills shortages, an aging workforce and, in some regions, a reliance on non-UK born workers. Data from the UK Data Service, which provides a more granular breakdown on the ONS' Quarterly Labour Force Statistics, helps shed light on the latter two points, with the drop-off in EU workers of particular concern.

Between Q3 2019 and Q3 2020, the number of EU born workers in the construction industry declined by over a quarter, with this rising to 30% in London. It looks likely that the coronavirus has persuaded many workers to leave the UK and it is too early to say whether they will return once things improve. For several years, the proportion of the construction workforce made-up of EU workers has been shrinking and this could have a stark impact, particularly in London. Based on this dataset, in 2017, approximately 40% of the London workforce was EU born. This was over four-times the national average, but this has since fallen dramatically. Despite some of the losses being made up for by an increasing number of UK and other nationalities, the overall number of workers in London is also down. As a result, wage pressures could rise sharply, particularly if new work picks up, but also simply from workers becoming more confident once the difficulties of the coronavirus ease.

SUBSTANTIAL DROP-OFF IN EU BORN WORKFORCE



While not as remarkable, and also requiring a slightly longer perspective, data from the same source clearly shows the industry aging over the past ten years. Averaging out data for 2010, and for the first three quarters of this year, the proportion of the industry aged under 30 had fallen from approximately 23% to just under 20%. Similarly, the share of those over 55 had increased from around 18% to 22%, with the 50-54 age group now the largest category. The pandemic also appears to have caused a significant drop-off in the number of apprentices, only worsening the situation. If over the next ten years significantly more people retire from the industry than join, problems with skills shortages will increase leading to higher wages.

One caveat we do have to apply to this analysis is that the ONS is facing considerable difficulties with its Labour Force Survey. Typically, the survey involves face-to-face interviews and, by conducting telephone interviews instead, the data has skewed towards homeowners instead of renters. This may create particular problems for immigrant and younger workers. In addition, the more detailed breakdown of workers by place of birth has considerable confidence intervals and needs treating with some caution. Problems with the data are also why the graph starts in Q3 2017. However, irrespective of the exact accuracy of the latest data, the trends, even before the pandemic, were pointing in the wrong direction. Unless there is a reversal, inflationary pressure from wages could drive tender prices up. Alternatively, and there is already a push towards it, offsite construction becomes a more cost effective and desirable solution.

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