WT PARTNERSHIP

Review of UK Construction Market Conditions 3Q 2020

WT

Summary

Since our last report, the Covid-19 pandemic has accelerated around the world causing many tragic deaths and has largely shut down large sections of the global economy, including construction.

On 23rd March 2020, the Prime Minister imposed lockdown on the country which saw hundreds of construction sites forced to shut down. Over subsequent weeks, and following the peak of Covid-19 cases reached in the UK, there has been a gradual easing of the lockdown restrictions and sites have now been slowly re-opening albeit with strict site operating procedures in place which place restrictions on working practices.

As of the end of April 2020, 4,800 construction projects with a value of £68 billion had been put on hold in the United Kingdom due to the impact of coronavirus. On Sunday 10th May 2020 the UK Prime Minister, Boris Johnson, announced that construction and manufacturing should begin to re-open sites.

Large Contractors and Housebuilders are now re-opening sites across the UK where it is safe to do so and are learning to balance productivity and the need to adapt to social distancing measures put in place by the Government. In tandem with this, a number of manufacturers are beginning to re-open their factories in a bid to tackle the issue of material shortages. Also, more builder's merchants are making plans to re-open across the country to support the supply chain.

There are a wide range of forecasts on the damage the pandemic could do to the UK economy which makes predictions on the effect it will have on the construction industry very difficult to determine. On the basis that the virus is brought under some sort of medical control, then many forecasts point to a steep but relatively short-lived contraction that will mostly affect activity in the first half of 2020 with a partial recovery expected in the second half of 2020. Some commentators are predicting a much bigger bounce-back as soon as restrictions are lifted.

Gross domestic product shrank by 20.4% in April 2020, the largest monthly contraction on record, as the UK spent its first full month in lockdown. The contraction is three times greater than the decline seen during the whole of the 2008 to 2009 economic downturn. However, analysts have said that April was likely to be the worst month, as the government began easing the lockdown in May.

The ONS also published figures for the three months from February to April 2020, which showed a decline of 10.4% compared with the previous three-month period. Construction shrank by 18.2% over this period, which was second only to accommodation and food services (40.9% fall) as the worst performing sector.

In early May 2020, the Bank of England had warned that the UK economy might contract by 25% in the April-June quarter while the economy this year could shrink by 14%.

More recently, the UK government has outlined plans to restart activity and get those who cannot work from home, back to work. Those in construction and manufacturing are encouraged to return to work whilst hospitality is expected to remain closed until at least July 2020. The government is operating a 'coronavirus job retention scheme which covers, through a furlough process, payment of 80% of the wages of those currently not working up to £2,500 a month. This scheme was originally due to end at the end of June 2020 but was extended to the end of October 2020 by the Chancellor Rishi Sunak but with greater flexibility to support the transition back to work.

This scheme is currently helping to pay the salaries of 7.5 million workers. The Construction Leadership Council has revealed that more than eight out of ten firms in the industry are using it.

Looking forward, there is a real risk that sectors like construction will be severely damaged unless collective steps are taken to modify working practices to protect the health of the workforce, manage the resilience of the supply chain, deal effectively with contractual claims and to preserve the industry capacity for the uncertain times that lie ahead.

Contractors will not be able to make up time lost on jobs while site workforces remain reduced because of social distancing restrictions. In order to mitigate this, Contractors are introducing a range of measures to make sure government guidelines are being followed such as dual entrances, additional welfare facilities and staircases. Multiple shift patterns have been introduced and workers are being encouraged to walk or cycle to work.

Despite inevitable reductions to demand and continuing Brexit uncertainty further paring back investment, there is potential for inflationary pressures to counterbalance deflation. In addition, parts of the supply chain could see reduced capacity from insolvency, lower on-site productivity due to social distancing measures and disruption to domestic supplies and imports of construction materials.

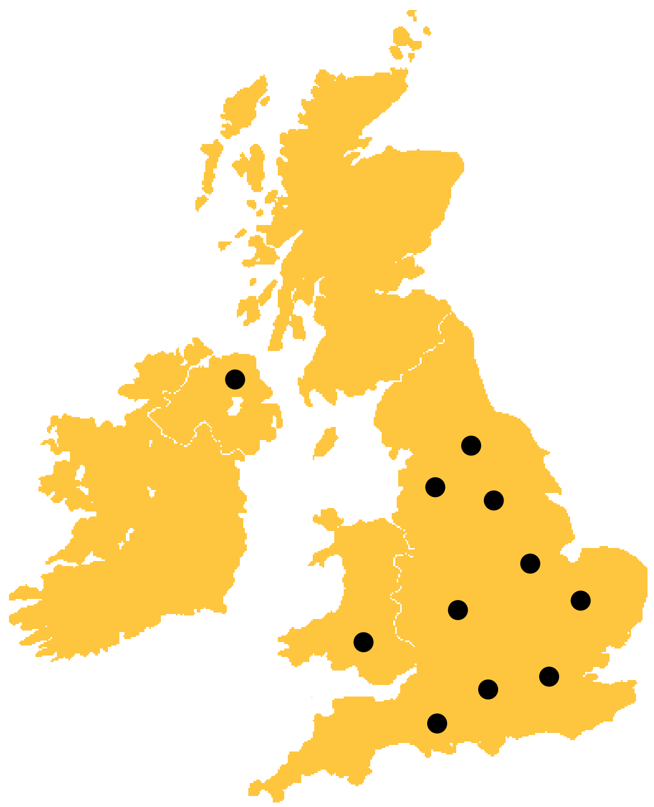
In view of the global economic havoc caused by the Covid-19 pandemic and the ongoing Brexit uncertainty we have reviewed and made some substantial downward adjustments to our tender price inflation projections.

WT Partnership are now forecasting that tender prices will rise nationally by 0.6% in 2020, 1.2% in 2021 and 2.1% in 2022. For Central London, tender prices are also forecast to rise by 0.6% in 2020 but with higher projected rates of 1.3% in 2021 and 2.6% in 2022.

For further information please contact

Paul Goldstraw
Joint Managing Director

t: 0208 686 0431
e: paul.goldstraw@wtpartnership.com



WT

Construction Activity

Month on month, chained volume measures, seasonally adjusted, Great Britain, April 2020 compared with March 2020

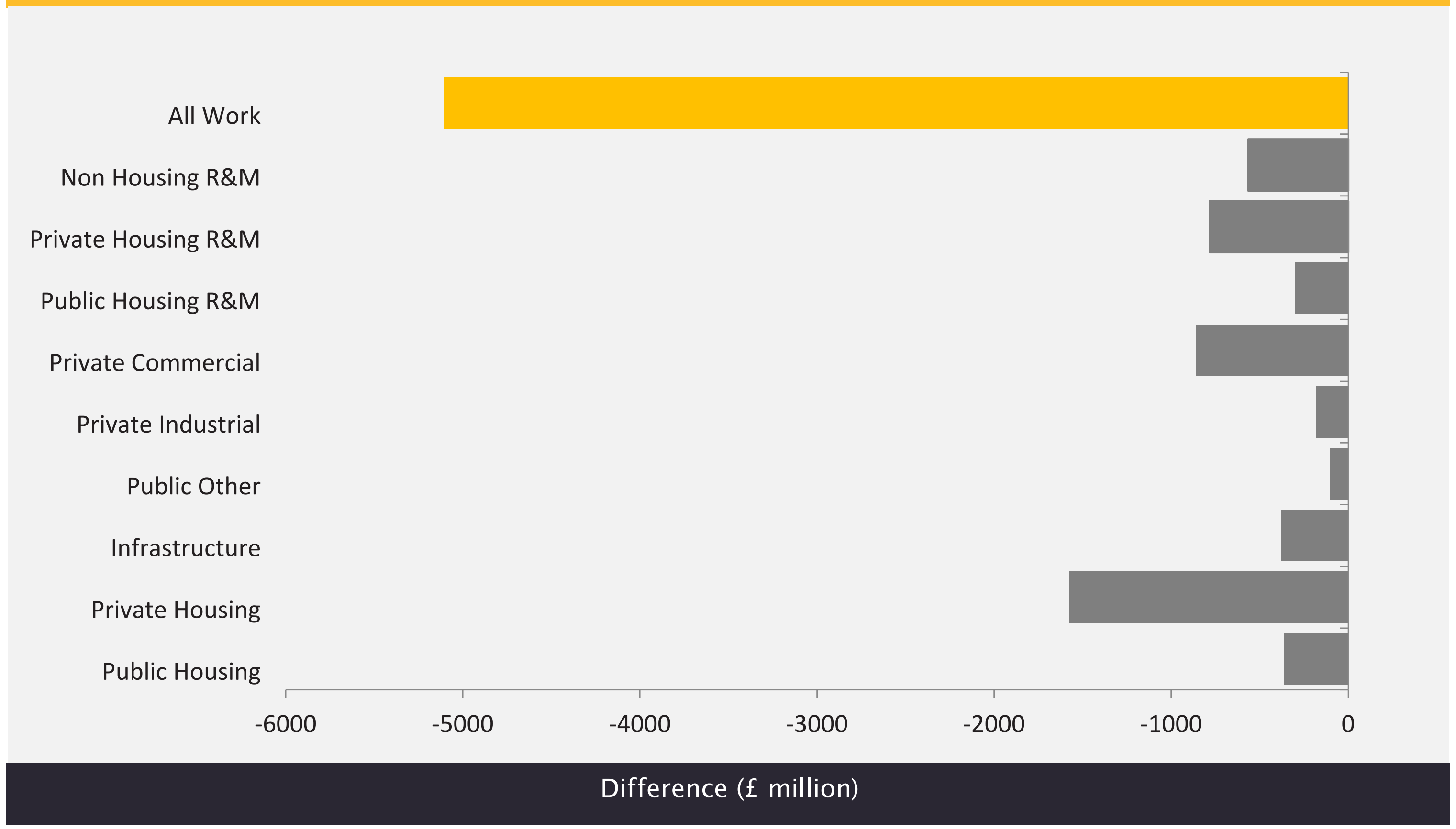


Table 1 (above) shows the month-on-month chained volume measures for all construction sectors as a comparison of April 2020 with March 2020, prepared by the ONS. New work fell by 41.2% (£3,460 million) with the largest contribution coming from private new housing which fell by 59.2% (£1,574 million). Other large contributors to the record decrease in new work came from private commercial new work, which fell by 39.7% (£859 million), with infrastructure and public new housing also seeing record monthly decreases of 20.3% (£378 million) and 66.5% (£361 million) respectively. Repair and maintenance work fell by 38.1% (£1,644 million).

Widespread site closures and business shutdowns across the construction supply chain during April 2020, meant that vast swathes of the construction sector either reduced or halted all activity in response to the Covid-19 pandemic.

Much of the property and construction industry will inevitably face supply chain issues over the coming months. The impact on these issues on capital cost works and on the costs arising from delays to design, procurement and construction programmes will need to be calculated and taken into consideration.

Gross domestic product fell by an unprecedented 10.4% in the three months to April 2020 according to the ONS. Government restrictions on movement due to the Covid-19 pandemic has dramatically reduced economic activity in the United Kingdom. April's fall in GDP is the biggest the UK has ever seen, more than three times larger than last month and almost ten times larger than the steepest pre-Covid-19 fall. In April the economy was around 25% smaller than in February.

Output in the construction sector fell by 18.2% over the same period and in the month from March 2020 to April 2020, fell by 40.1% (£5,105 million). This is the largest month-on-month fall since monthly records began in 2010.

The construction PMI for April 2020 indicated by far the fastest decline in UK construction output since the survey began 23 years ago. Most survey respondents (86%) reported a reduction in business activity since March, mirroring widespread site closures and shutdowns across the supply chain in response to the Covid-19 pandemic.

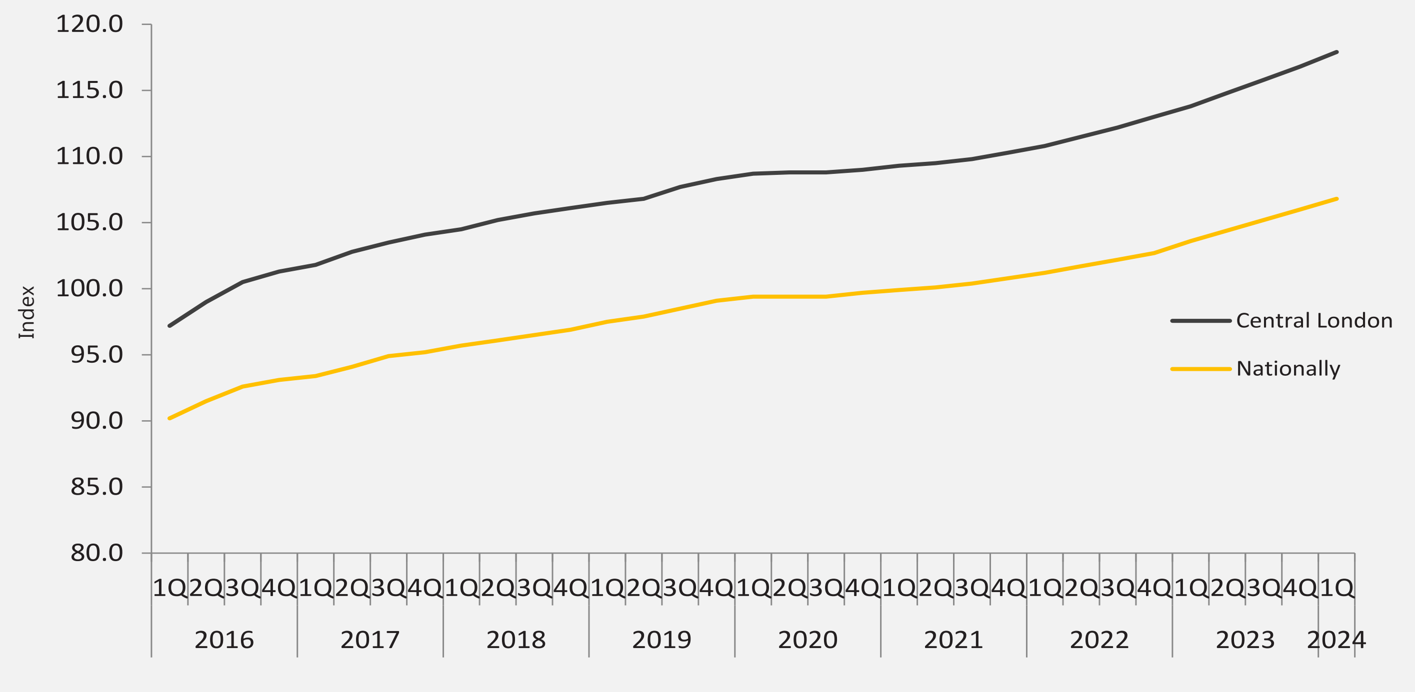
The headline seasonally adjusted IHS Markit/CIPS UK Construction Total Activity Index fell from 39.3 in March 2020 to 8.2 in April 2020, signalling a rapid downturn in overall construction output. The previous record low was 27.8 in February 2009. All three main categories of construction work experienced a survey-record fall during April with house-building been the worst affected sector, with a fall in construction output of c85% during the lock-down phase.

The construction PMI rose to 28.9 in May 2020, which was still the second-sharpest contraction in the sector since February 2009, but reflected a gradual reopening of construction sites as lock-down measures were eased in England.

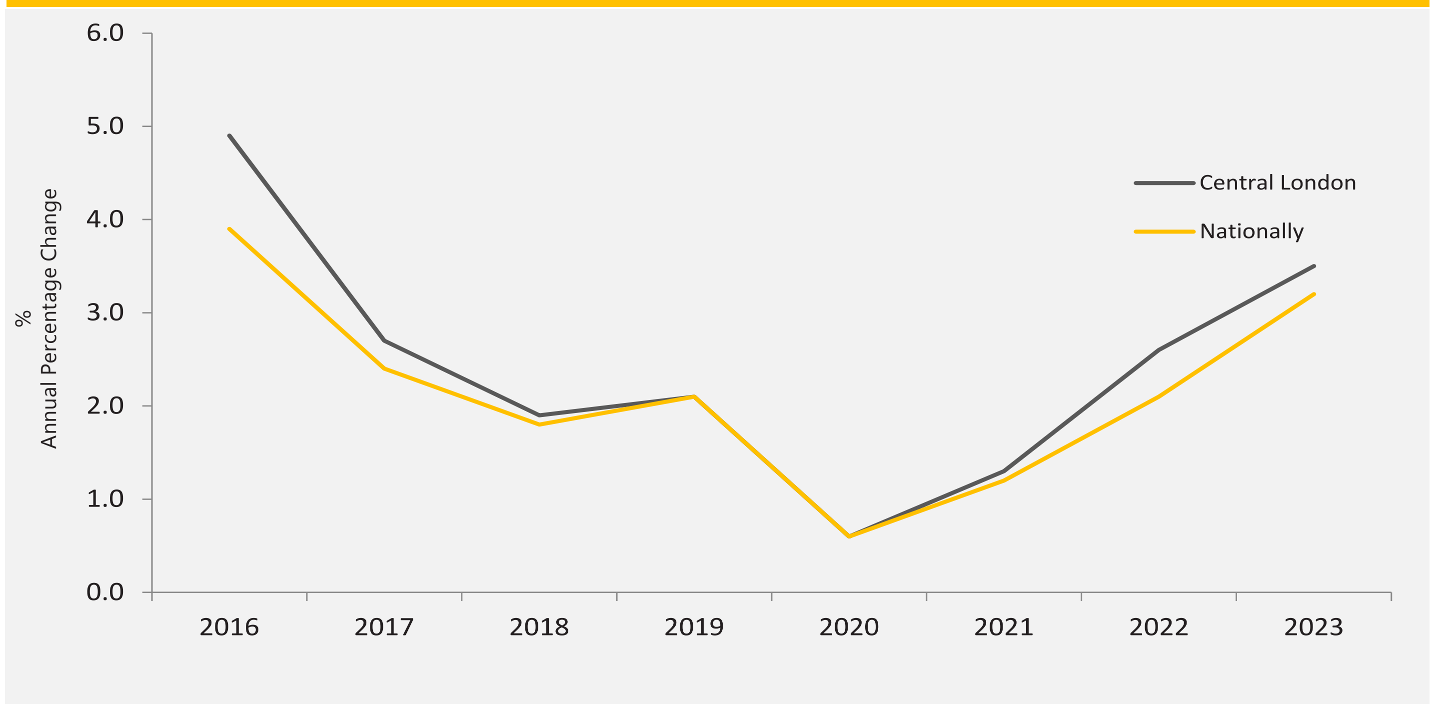
WT

Tender Price Inflation Forecasts

WT Partnership - Tender Price Inflation Trends



WT Partnership - Tender Price Inflation Forecast



As mentioned in the summary, WT Partnership have made some significant downward revisions to our tender price inflation projections since the issue of our last report. Tender prices are now forecast to rise nationally by 0.6% in 2020, 1.2% in 2021 and 2.1% in 2022. For Central London, tender prices are also forecast to rise by 0.6% in 2020 but with projected rates of 1.3% in 2021 and 2.6% in 2022.

We would recommend that these forecasts are treated with some caution, due to the supply-led nature of the current Covid-19 crisis being ultimately different from the demand-led nature of previous recessions. These tender price projections assume a reasonable market correction to the current unprecedented events. If the longer term market correction proves to be deep and protracted, then tender prices could potentially enter negative territory as last seen in the correction after the financial crisis between 2008 and 2011.

The supply chain will need to reassess its appetite to pricing and risk allocation in response to an emerging market likely to be characterised by drastically reduced demand for capital projects. In making tender price forecasts each project needs to be reviewed on its own merits and will also vary dependent on the building type, size and its location. Particularly in the current market, Contractors will adjust their pricing dependent upon the risk profile of individual projects which is determined by such factors as client body, extent and quality of design, procurement route, time-scales and quality of specification.

There are a number of inflationary and deflationary pressures which are currently impacting on input costs and tender pricing:

Inflationary pressures include:

a) Reduced on-site productivity due to government guidelines including social distancing
b) Material import difficulties due to Covid-19 and Brexit
c) Labour supply restraints
d) Clearing backlog of work following lockdown
e) Insolvencies lowering industry capacity and reducing tendering competition
f) Additional costs as a result of implementing new Site Operating Procedures

Deflationary pressures include:

a) Falling raw commodity prices
b) Labour costs falling due to site closures and complying with new SOPs
c) Downward trend in Contractor's margins as work pipeline falls
d) Increased competitive tension

This is a period of great financial risk, as many businesses will be looking at cash flow preservation irrespective of end of project margins as they can trade problems from one project to another. In particular, the pricing of overheads and profit is highly elastic and tends to compress and expand very quickly in response to market conditions and outlook. If pricing is too short then liquidity reduces quickly with little balance sheet strength. This creates an unprecedented risk that more companies will fail and therefore financial viability needs to be a major area of main contractor and supply chain selection due diligence.

WT

Procurement

Two stage procurement, usually design and build, continues to dominate on larger projects despite the well documented risks to cost and programme that have been encountered on some projects over recent years. This procurement route typically ends with an extended negotiation period at the end of the second stage.

However, with the recent significant decline in construction output, single stage tendering is likely to become more prevalent with Contractors' having an increased appetite to take on additional commercial risk in order to secure work.

Single stage procurement is generating keener pricing and is preferred by many clients as the overall price is largely known up-front and provides certainty to all investors. This route also avoids prolonged pre-contract periods that tie up resources better deployed on already secured projects.

Single stage tendering does however involve a higher tender cost to the Contractor with only around a 25% chance of success. The Contractor will also not have contributed to the construction management plan or helped to shape the programme at an early stage which may result in issues further down the line.

Where procurement is construction management, Contractors are accepting lower margins compared with design and build, but this is largely due to the allocation of risk remaining with the client.

There is an opportunity now for clients and their teams to actively rethink how they engage with the market and how they manage risk, quality, cost certainty and performance rather than necessarily go for lowest price. Keys areas for clients and their advisers to concentrate on in order to develop more resilient and effective delivery strategies for projects will include:

a) Due diligence in supply chain selection needs to be robust and based on balance sheet strength, product quality, team competence and track record. Standard credit checks in themselves are not enough.
b) Ascertaining a realistic and accurate project budget and programme at the onset and at least prior to procurement of the works. Risk needs to be analysed, allocated appropriately and integrated into the project plan.
c) Design needs to be resilient at an early stage and allow for its implication at the supply and construction phases. Greater standardisation and pre-fabrication should be considered.
d) Domestically sourced and readily available materials including ease of transportation should be explored
e) Innovative delivery strategies to help promote collaboration including earlier engagement of the market, project bank accounts and integrated procurement.

Various hybrid procurement solutions are now regularly considered which use the advantages of both the single stage and two stage routes. Typically a Contractor might price 80-90% of the works as part of the first stage with the second stage used to firm up prices. Clients get the certainty they need while the Contractor follows their preferred two-stage process.

In the current downward market, there might be a temptation to reduce risk premiums in order to secure work, but this should only really be as part of a measured risk management strategy by both the client and contractor.

WT

Economic Indicators

Unemployment

Unemployment rose by 50,000 to 1.35 million (3.9%) in the three months to March 2020 according to the ONS. This period only covers the first few weeks of the covid-19 restrictions and furloughed workers still count as ‘employed’. Unemployment is expected to rise to 9% according to forecasts.

Inflation

Inflation as measured by the Consumer Prices Index was 0.9% in April 2020, down from 1.5% in March 2020. Falling energy and fuel pump prices resulted in the largest downward contributions.

Interest rates

Bank interest rate was reduced from 0.25% to an all-time low of 0.1% in March 2020

Brent crude oil prices

Brent crude oil is currently priced at $30.97/barrel (11th May 2020) which is 56.15% less than the same time last year. Stocks are exceeding demand due to the coronavirus. From 1st May 2020, the Opec+ group began cutting production, driving offshore prices down however the continued oversupply of oil will keep utilisation of tankers high.

Gross domestic product

GDP

Gross domestic product shrank by 20.4% in April 2020, the largest monthly contraction on record

Sterling

Sterling has fallen to $1.2431 and E1.1455 (as at 11th May 2020) which is a fall of 4.62% and 1.20% respectively over the year.

Public sector net borrowing (PSNB)

Public sector net borrowing (PSNB) in the current financial year to date was £48.7 billion, up by £9.3 billion from the 2018/19 financial year. This is expected to deteriorate rapidly.

UK average house prices

UK average house prices from Land Registry data is £231,855 as at March 2020 and has risen by 2.1% compared to the previous year. This does not reflect recent fall in house prices due to the covid-19 pandemic

Corporation tax

19%

Corporation tax is currently 19%. The UK has one of the lowest corporation tax rates in the developed world.

FTSE 100

FTSE 100 is very volatile and is currently standing at 6,105.18 (12th June 2020) a fall of c15% over the year.

VAT

20%

Rate for the UK remains at 20%.

WT

Input Costs

Wage inflation

With the completion of current committed construction projects and a likely dearth of new projects, more site labour will become available in the market and recently seen skills deficits will be masked by a possible over-supply of labour. This will lead to a reduction in trade day-rates, the level of fall will be determined by levels of foreign labour repatriating and the usual leakage of workers who leave the sector completely in a downturn and move into other lines of employment.

The government is proposing a skills-based immigration system as part of its post-Brexit planning which may include minimum salary requirements. The Federation of Master Builders is calling for this to be scrapped so that ‘essential migrant workers’ can still enter the UK.

Commodity and material price inflation

Factories have been shut down due to Covid-19 and will be carrying fixed manufacturing overheads with low or zero output putting them under financial pressure.

Supplier pricing and merchant on-costing will be driven by product demand and their own capital reserves. There has been more prudent management of work in progress by material suppliers since the last market crash in 2009 so it is likely to mean that there will not be a collapse in materials pricing in the period ahead.

We could see aggressive pricing and large-scale supply from Asia as they look to rebound from the economic turmoil but transportation of materials and customs hold ups remains a big project risk.

Material prices are subject to raw material prices and commodities fluctuations and it is difficult to see how the current crisis will play out in terms of supply and demand for various basic commodities. We have already seen a dramatic collapse in the price of crude oil which could in turn feed through to manufacturing process and transportation costs. It is likely that pricing will become more erratic both upwards and downwards as supply adjusts to new levels of demand in the medium to longer term.

The final variable is the possible future impact of Brexit on tariffs and import logistics issues. It may also introduce a currency dynamic in terms of the strength of sterling relative to our main import markets beyond just the EU. The government has recently confirmed that it does not intend to seek an extension to the current timetable and the risk remains of a no deal Brexit at the end of 2020 which would completely re-shape the price and availability and price of EU sourced materials.

Offices in:

Australia
Canada
China
Germany
Hong Kong
India
Indonesia
Italy
Macau
Malaysia
Mexico
New Zealand
Singapore
Spain
Sweden
United Arab Emirates
United Kingdom
United States
Vietnam

WT Partnership is an award-winning, international construction cost and project management consultancy which, from our initial base in quantity surveying, has evolved into a multi-disciplinary practice offering a wide range of services and delivering successful cost, time, quality and environmental outcomes for our clients.

With main activity in the UK, mainland Europe, North America, Asia and Australasia, we draw upon the expertise of 1,300 employees operating from over 72offices worldwide.

www.wtpartnership.com