WT PARTNERSHIP

REVIEW OF UK CONSTRUCTION MARKET CONDITIONS 1Q 2019

WT | Summary

At the time of writing, events around the world were moving at a very fast pace creating widespread uncertainty in the international markets. In France, street protests in many cities including Paris have forced President Macron into a humiliating U-turn over fuel tax rises and a rise in spending which puts it in breach of Eurozone rules. The Italian government is already locked in dispute with Brussels over its rule-busting budget and other governments across central and Eastern Europe continue to pursue policies which seem to breach EU law.

All of this against the backdrop of US trade sanctions on many countries including China, and the increased likelihood of a 'no-deal' Brexit in the UK, means that this widespread uncertainty is taking its toll on the world economy. Global growth forecasts for this year have been downgraded with slowing trade due largely to deteriorating consumer and business confidence. China's economy is now growing at its slowest rate (6.4%) since 1990.

The Italian economy contracted in 3Qtr 2018, Germany has reduced its GDP estimate for this year from 1.8% to 1.5% and the Berenberg Bank is forecasting growth of only 1.25% for the eurozone in 2019. The Bank of England has cut its UK growth forecast for 4Qtr 2018 from 0.3% to 0.2% and expects slower growth to continue into 2019.

In the UK, ONS statistics show that new orders in construction have fallen over 2018 and are now well down on levels typically seen over the last five years. Meanwhile, the Construction Products Association has downgraded its growth forecast in 2019 from its previous estimate of 2.3% to 0.6% and has advised that the supply chain faces a triple threat of rising costs for labour, materials and fuel.

However, measures announced in the budget at the end of October 2018, including a multi-billion pound funding boost for the NHS, is expected to lift growth by 0.3% over the next few years according to the Bank of England. The Chancellor also announced new infrastructure schemes in the budget including a £28bn national roads fund, an east to west rail upgrade, works to M6 to introduce smart technology and the world's largest offshore wind farm (Hornsea Project One).

At the time of writing, the proposed deal with the EU put forward by Theresa May was overwhelmingly rejected by Parliament although the PM did survive a subsequent vote of confidence. Her government is now trying to seek cross party consensus on a way forward which will prevent the UK leaving the EU in 2019 without a deal. The biggest risks of Brexit to the UK construction industry, continue to be access to the EU market in respect of labour supply but also possible tariffs on imported materials and components.

The construction market is becoming more competitive as output falls and there is a growing return to single-stage tendering and an increased appetite by the Contractor to take on additional risk. Clients need to remain cautious on what risk is actually being taken on and managed by Contractors. The recent failure of Carillion and the rising number of insolvencies suggests risk transfer in the current environment can be illusory.

Housebuilding in the UK continues to rise with government figures showing that 222,000 homes were built in England in the year to April 2018 but falling short of the target of 273,000. However, northern and midlands regions exceeded their targets but the southern regions largely failed to meet their targets. In London the Mayor's own targets of 65,000 homes, included in the London Plan, fell woefully short with a building rate of 31,273 homes which is a fall of 20%. This is thought to be largely due to the Brexit effect, but also the higher tax threshold included in the stamp duty reforms which is hitting London homes to a greater extent.

We have made slight changes to our tender price inflation projections since the issue of our last report. Tenders prices are now forecast to rise in Central London by 2.3% in 2019, 3.0% in 2020 and 3.5% in 2021. For the remainder of the UK, tender prices are forecast to rise by 2.1% in 2019, 2.5% in 2020 and 3.0% in 2021. These revisions reflect concerns over the potential economic slowdown and continuing uncertainties surrounding Brexit, despite the inflationary pressures that currently exist in the industry.

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Construction Activity

Statistics on construction output continue to be volatile with the latest data from the Office for National Statistics showing a rise of 2.1% for November 2018 after a fall of 0.2% in October 2018 and a rise of 1.7% in September 2018. This latest rise was driven by all new work, which increased by 3.4%, but was offset slightly by a decline in all repair and maintenance which fell by 0.4%. The increase in output for all new work was driven primarily by private new housing and infrastructure which increased by 4.9% and 6.5% respectively.

The recent increase in the value of construction output still reflects, in part, a recovery following the relatively weak start to 2018, in which construction output fell by 1.6% in the weather-affected first three months of the year.

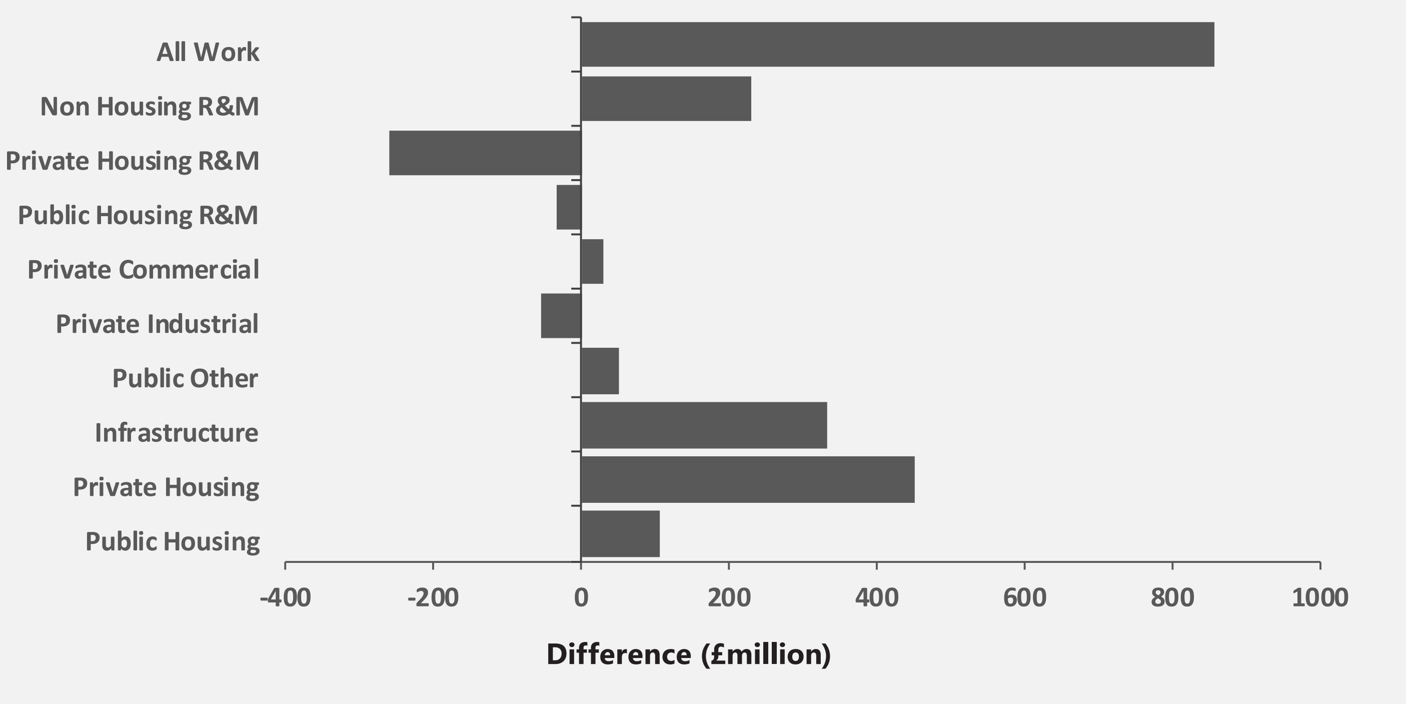
There is evidence of a slow-down and tightening of the London market and, whilst it still dominates over other regions, its pace of growth is less than elsewhere.

According to data from IHS Markit, the services sector, which includes construction firms, has had its worst quarter since 2012 with growth of just 0.1% in the final quarter of 2018. Firms remain reluctant to take on new staff, clients are delaying orders and consumer demand is subdued in a sector accounting for more than three-quarters of overall growth.

The Construction Products Association has downgraded its forecast for growth in construction to 0.6% from its previous estimate of 2.3% blaming Brexit uncertainty and infrastructure delays.

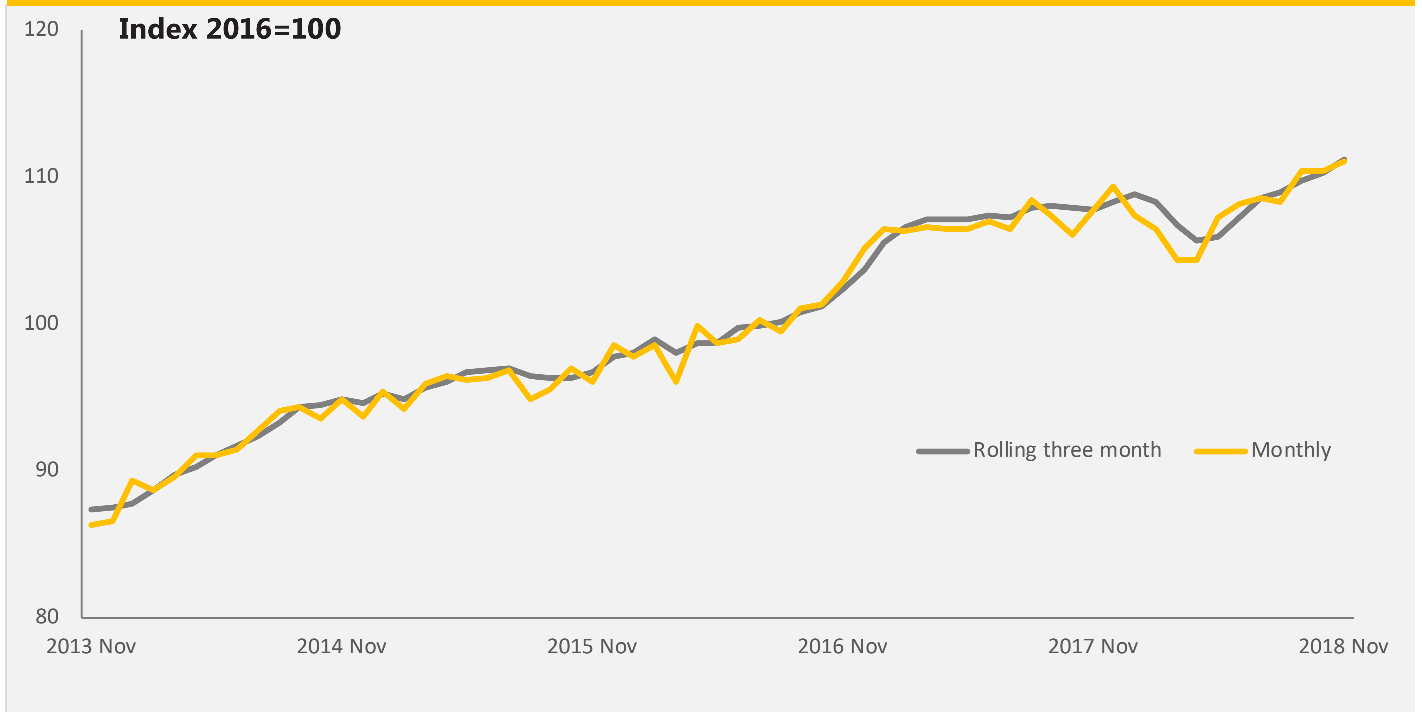
The latest report from Markit, with data from the Markit/CIPS Purchasing Managers Index, shows that growth in the UK construction sector slipped to a three month low in December 2018. The index dropped to 52.8 in December compared to 53.4 in November due to subdued demand and unusually wet weather. Commercial building was the worst performing category while civil engineering was the strongest.

Difference in three-month on three-month seasonally adjusted, chained volume measure from the main construction sectors - September to November 2018 compared with June to August 2018, Great Britain



Source: Construction: Output and Employment - Office for National Statistics

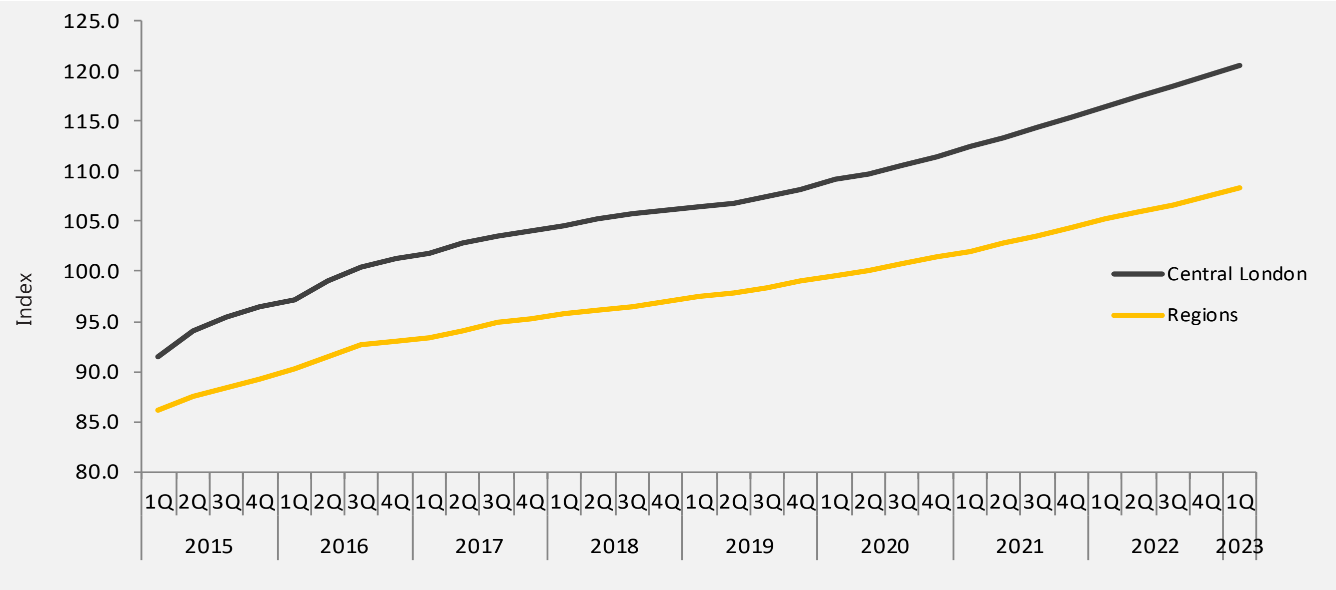
Rolling three-month and monthly all work, November 2018
Chained volume measure, seasonally adjusted, Great Britain



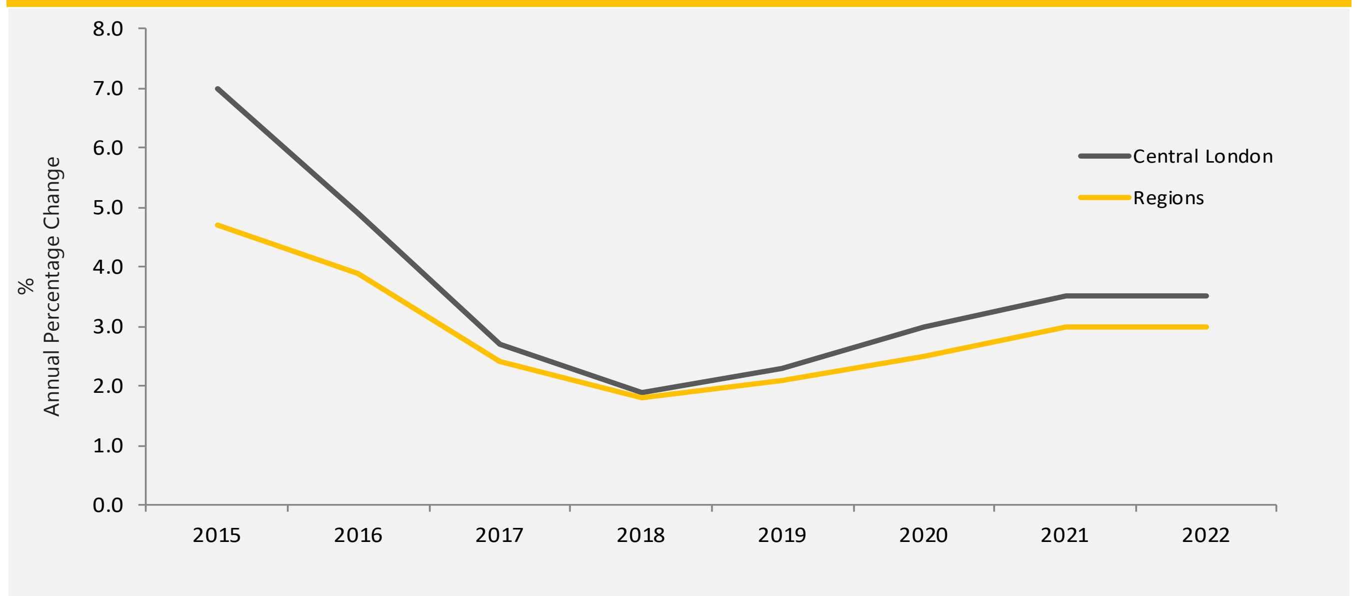
Source: Construction: Output and Employment - Office for National Statistics

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 downward revisions to our tender price inflation projections since the issue of our last report. Tenders prices are now forecast to rise in Central London by 2.3% in 2019, 3.0% in 2020 and 3.5% in 2021. For the remainder of the UK, tender prices are forecast to rise by 2.1% in 2019, 2.5% in 2020 and 3.0% in 2021.

The reduction in our forecasts from the previous report is largely due to the damage to confidence resulting from the previously mentioned political and economic shocks with the resultant discounting of tender rates by the construction supply chain. Looking forward, future construction activity is expected to be modest in comparison with recent years, and the length of time this continues will be largely governed by the period of time it takes to resolve the domestic and international uncertainty.

Contractors are keen to fill their order books for 2019 and 2020 as there is a general acceptance that we are entering a flatter period of growth, margins may have to be squeezed despite rising input costs, to ensure that tender prices remain stable and competitive. Therefore, we are likely to see more tactical pricing from Contractors and their trade contractors with the consequent variability in tender spreads although these are not anticipated to fall outside expected ranges.

However, despite this, we are finding that the pricing of preliminaries and OHP is at or near prevailing benchmark levels which suggests that the construction industry is still relatively robust albeit a firm in a weaker position and included on a tender list may distort this collective stance.

Looking ahead on Brexit, a soft agreement with the EU, which incorporates a suitable transition period, would have a relatively limited impact on tender prices and will likely boost demand as paused schemes in the pipeline come back to the fore. Any deal is expected to introduce greater restrictions on EU labour flows which could deter some EU migrants from choosing to work in the UK and which could aggravate construction wage inflation. A hard Brexit, without a deal, is likely to greatly impact on business confidence and the impact on the cost of building could be significant with elevated input costs, capacity constraints and exchange rate fluctuations.

Procurement

As previously mentioned, there is increased competitive tension in the market with Contractors now actively looking to fill their order books for 2019 and 2020, especially at tier 2 and tier 3 level.

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. However, with the decline in construction output, single stage tendering is becoming more prevalent with Contractors' having an increased appetite to take on additional commercial risk. This is more prevalent in what are perceived as lower risk markets, with the high end residential sector still seen as being higher risk.

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 with the client.

Following the collapse of £5bn turnover Carillion earlier this year, Interserve has now confirmed that it is in rescue talks that would see the firm hand much of the control of the business to its lenders in a debt-for-equity swap. In view of the current challenging economic conditions with many projects on hold and creditors unpaid, there will continue to be the potential for suppliers and sub-contractors to experience financial difficulties which could yet translate into further insolvencies. Clients should ensure that proper financial checks are carried out and guarantees are in place on all of their projects.

It still holds true that a well set up project and procurement strategy with a developed, co-ordinated and de-risked design, smartly presented to the market with active engagement of the supply chain will avoid some of the extreme outcomes that have been seen in the market over recent times.

Closer collaboration between clients and the supply chain will help in the management of risks and help to avoid some of the more extreme effects on projects and be a key factor in getting projects to site successfully.

Economic Indicators

Unemployment

Unemployment has risen with 20,000 more in August to October 2018 than for May to July 2018, but 49,000 fewer than for a year earlier. This brings the total number of unemployed to 1.38m, or 4.1%, which is lower than the equivalent rate of 4.3% a year earlier. (ONS).

Inflation

Inflation as measured by the Consumer Prices Index was 2.0% in December 2018, down from 2.2% in November 2018. The largest downward contribution comes from falls in petrol prices and from air fares. This easing of inflation is in line with the Bank of England's target of 2.0%.

Interest rates

Bank interest rate was raised from 0.5% to 0.75% in August 2018 and the BoE Monetary Policy Committee has been reluctant to raise this further due to the uncertainty over Brexit.

Brent crude oil prices

Brent crude oil prices have risen by 38% over the year (Sept 2017 to Sept 2018) according to the BEIS which is one of the biggest contributors to increased inflation. More recently crude oil prices have fallen, despite US sanctions on Iran's energy industry.

Gross domestic product

GDP

Gross domestic product grew by 0.6% between 2nd Qtr 2018 and 3rd Qtr 2018 according to the ONS which represents a 1.5% rise compared with the same quarter the previous year. GDP growth was driven mainly by the services sector, though the production and construction sectors were also positive contributors. However, the pace of expansion through to 2022 is likely to be well below the long-term trend at c1.6% according to forecasts.

Sterling

Sterling is still historically weak against both the Euro and the US dollar. The UK government's decision to abandon a vote on the Brexit deal during December 2018 triggered a drop in the value of the pound and it remains very volatile. However, sterling did gain some ground against the US dollar and the euro during 3rd Qtr 2018 although this was thought to be on the expectation that there would be some sort of Brexit deal with the EU.

Public sector net borrowing (PSNB)

Public sector net borrowing (PSNB) in the current financial year to date was £35.9 billion, £13.1 billion less than in the same period in 2017; the lowest year-to-date for 16 years.

UK average house prices

UK average house prices have fallen by the largest amount since 2011. The latest survey from Nationwide for December 2018 shows UK house prices now falling and overall grew by just 0.1% from a year earlier. The average property price was £211,966.

19%

Corporation tax

Corporation tax is currently 19% and is predicted to fall a further 2% next year. The UK has one of the lowest corporation tax rates in the developed world.

FTSE 100 & FTSE 250

FTSE 100 & FTSE 250 indexes have both fallen by c10% over the last 6 months.

20%

VAT

Rate for the UK remains at 20%.

Input Costs

Commodity and material price inflation

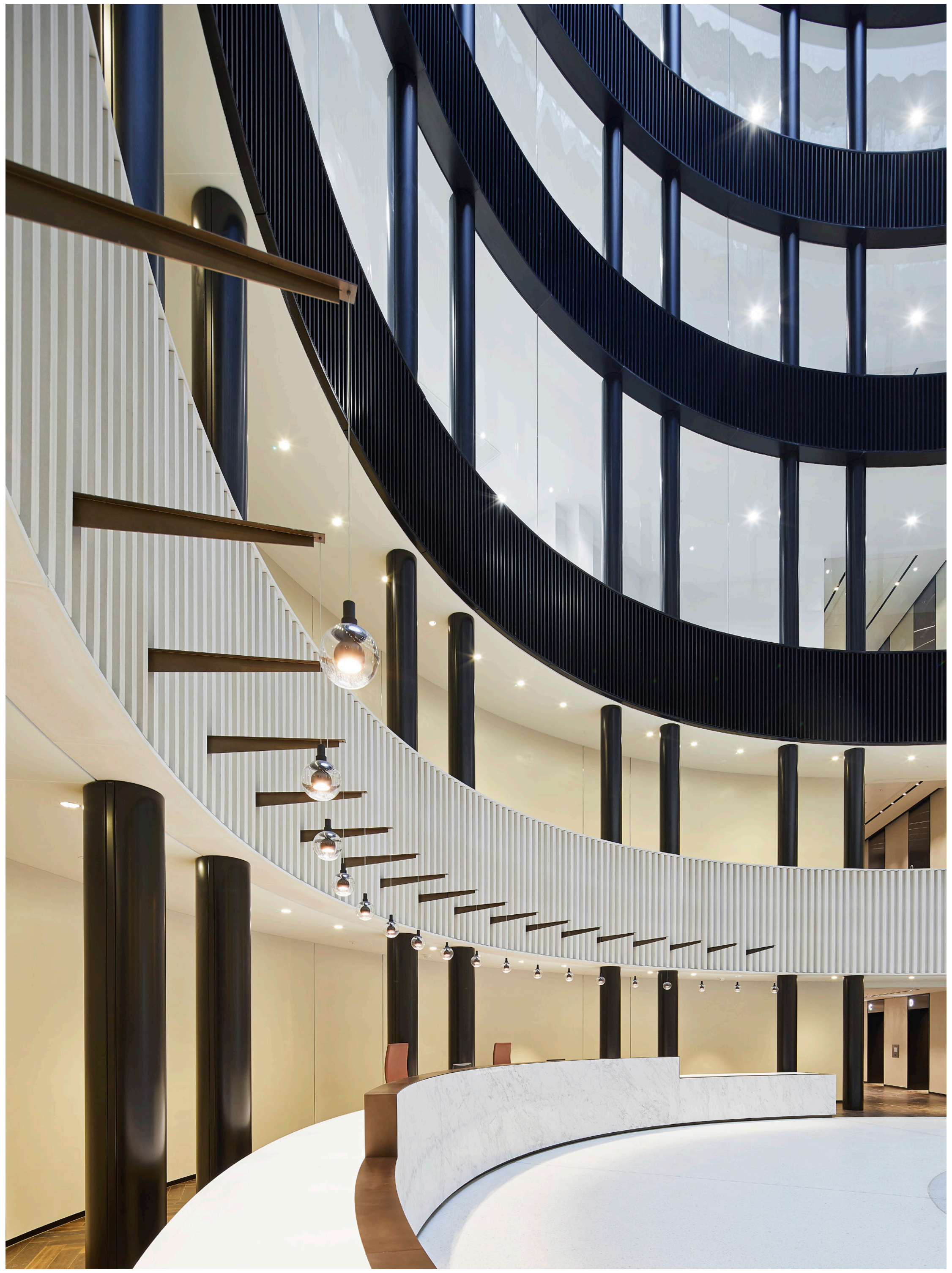
Commodity and material price inflation in the UK is strongly affected by currency fluctuations and any fall in the value of the pound will hit import prices and have an impact on Contractors. Commodity prices have however been heavily affected globally by the instability resulting from a stronger dollar (many commodities are priced in dollars), rising US interest rates, weaker economic data for China and increasing tension in global trade relations generally.

The Department for Business, Energy and Industrial Strategy (BEIS) Index of Construction Materials Prices for all work rose by 5.1% in the year to October 2018, which is down from the 5.8% seen in the last report, but is up by 0.5% from September 2018.

Looking ahead material costs could potentially rise further when the UK leaves the EU and needs to negotiate new trade agreements which could potentially result in higher import duties and tariffs. This could particularly affect commercial and residential schemes which have a greater reliance on imported construction technologies such as cladding, central plant, lifts, etc. Around 15% of products used in UK construction are imported from the EU.

Fabricated steelwork costs have risen by 9.4% over the year (Sept 2017 to Sept 2018), according to the BEIS.

Steel and iron ore prices remain historically low although, with the introduction of tariffs by the USA on EU, Canadian and Mexican steel imports, could be entering a period of volatility. Metal prices have fallen over the last year (Oct 2017 to Oct 2018) according to the LME with the biggest falls in aluminium (-36.1%), lead (-20.8%) and zinc (-18.4%).



Wage inflation

Currently 7% of the construction workforce in the UK are EU nationals and technically, without a deal on exiting the EU, will have no right to work in the UK.

However, 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.

Construction industry pay rates continue to rise ahead of average earnings, with average UK wages rising at or around 3% during 2018 but with construction pay averaging nearer 5% over the same period.

This continuing rise is due to the concern that many construction firms feel on the availability of labour and staff resources due to the uncertainty over future labour market restrictions resulting from the post-Brexit negotiations with the EU.

Various surveys are showing that the number of EU citizens coming to the UK continues to fall and UK employers are now starting to recruit outside of the EU to fill those gaps. According to the ONS, net EU migration was 74,000 in the year to November 2018, its lowest level since 2012.

The decreases in immigration of skilled labour are being worsened by an increased emigration of UK workers seeking overseas opportunities due to the reduced attractiveness of the UK market.

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