

# Review of UK Construction Market Conditions 4Q 2019





There have been increased signs of slowing global growth and talk of recession largely because of the trade war between the US and other countries including China and the EU nations. International events have taken place with political disturbances in Hong Kong, an attack on Saudi Arabia's oil and gas infrastructure and the recent incursion of Turkey into the Kurdish area of Syria. The global economy is growing at its slowest pace since the financial crisis, just 3% this year, according to the IMF in its report issued in October 2019.

There has also been considerable turbulence in the British political scene with the Conservative party losing its majority in parliament and the Supreme Court ruling that the new Prime Minister, Boris Johnson, acted unlawfully in suspending parliament. There are expectations that a general election will be held in the UK following the passing of the Brexit deadline of 31st October 2019. The Queen's speech of 14th October seemed to be the precursor to an anticipated general election campaign.

Construction output has been falling consistently since the start of this year, with only a brief period of activity during the summer, according to data from the ONS. Many construction companies are bracing themselves for a slowdown as there is a shortage of new work coming in to replace completed contracts.

In the event that the UK leaves the EU with a withdrawal agreement in place, then there is the possibility of a post-Brexit bounce which could lead to higher output growth than currently envisaged, although there will be an inevitable lag before this feeds into the market.

The date on which the UK is scheduled to leave the UK (31st October 2019) is imminent and, whether or not the UK leaves with a deal, Brexit is a landmark moment in this country's history. Contractors must have plans in place to manage the transition in order to avoid disruption in the short- and medium- term. Labour, materials, logistics and the supply chain (cladding, steel, MEP, insulation, etc.) will be directly affected by Brexit. Sourcing strategies will need detailed review, especially around imported materials as new customs regulations kick in.

With EU nationals forming nearly one-third of the London labour market, capacity shrinkage will be a reality unless contractors can tap into a non-EU workforce.

If sterling drops further in value, imported materials, plant and equipment will become a higher cost input. Materials may be subject to additional tariffs and if they are held up at ports and borders for any significant length of time the 'just-in-time' logistics, used by most Contractors, will be affected. Consolidation centres for bulk storage of materials may need to be considered to avoid delays on site.

In its worse-case scenario and in the event of a disruptive Brexit, the Bank of England expects GDP to contract by 5.5%, unemployment to rise by 7% and inflation to hit 5.5%.

There seem to be delays in large new infrastructure projects coming through and even HS2 is currently the subject of a major review due mainly to increases in projected costs for the scheme. This will inevitably be a challenge for civil engineering related trades, particularly ground works and piling, as all of the uncertainty will impede forward planning of resources.

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.

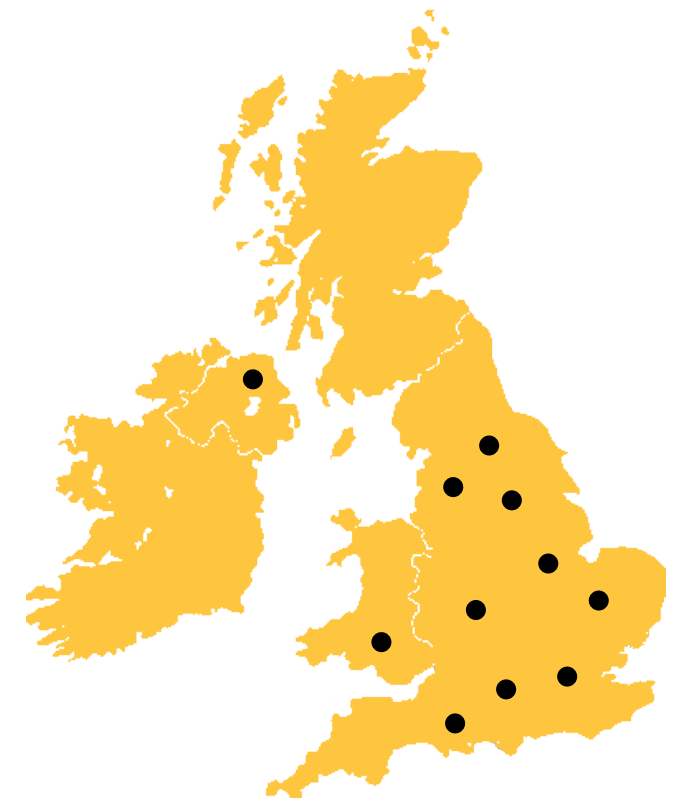
We have made slight changes to our tender price inflation projections since the issue of our last report. Tenders prices are now forecast to rise in Central London by 2.2% in 2019, 2.7% in 2020 and 3.0% in 2021. For the remainder of the UK, tender prices are forecast to rise by 2.1% in 2019, 2.7% in 2020 and 2.7% 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.



For further information please contact

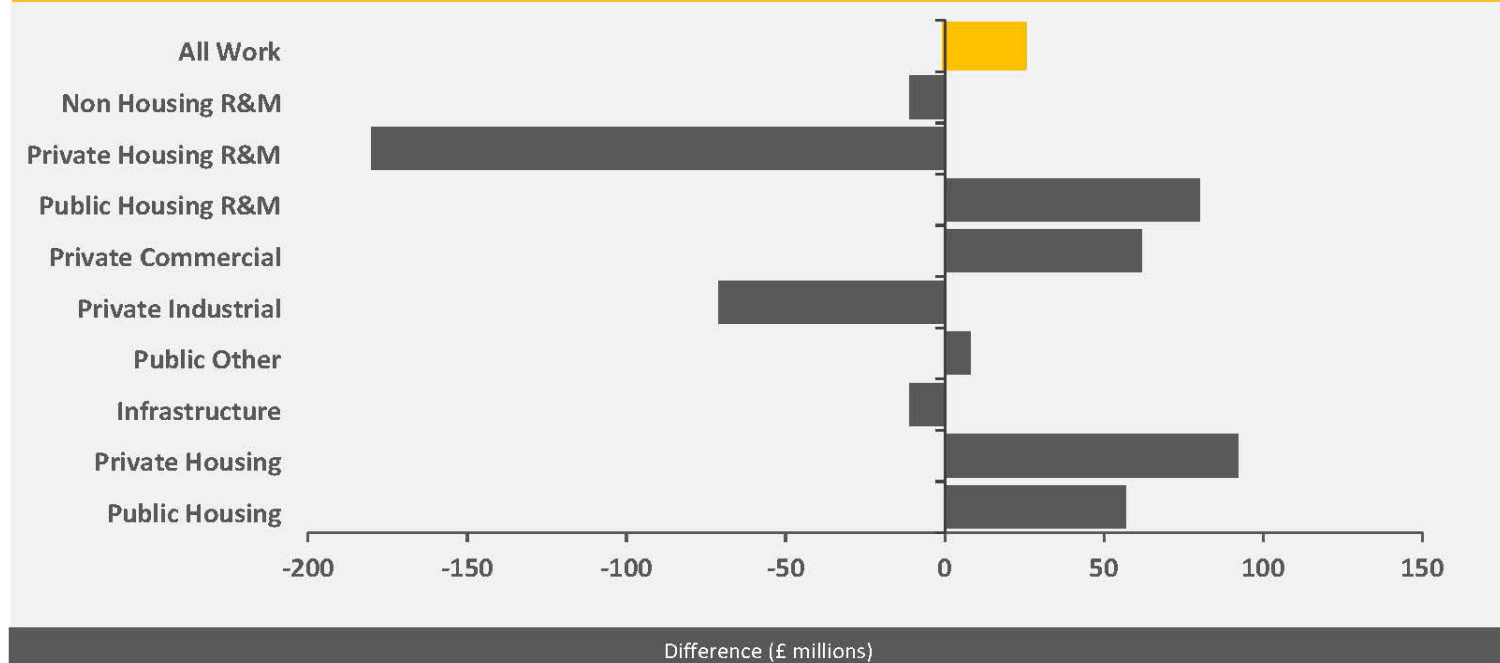
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**Three-month on three-month, seasonally adjusted, chained volume measure, Great Britain, June to August 2019 compared with March to May 2019**



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

*Construction output enjoyed a steady period of growth from early 2013 but, with the uncertainty created by Brexit, construction output growth has been relatively flat over the last two to three years.*

Construction output in 2Q 2019 rose by 1% to £41.05bn against the same period in 2018 according to the latest figures from the ONS. A record high of £13,869 million was recorded in the monthly all work series in February 2019 and the most recent report from the ONS shows that construction output in August 2019 was £123 million below this record high.

From the seasonally adjusted chained volume measure series published by the ONS, construction output increased by £25 million (0.1%) in the three months to August 2019, compared with the previous three months.

New work output increased by £136 million (0.5%) largely driven by increases in new housing, both private (£92 million) and public (£57 million). Somewhat surprisingly, the other notable increase in new work was private commercial work (£62 million) although these increases were partially offset by a fall in private industrial new work (£71 million).

In contrast to new work, repair and maintenance output declined by £111 million (0.8%) driven by a large fall in private housing (£180 million) and a lesser fall in non-housing (£11 million). Public housing repair and maintenance did see a rise of c£80 million.

Infrastructure also experienced a small drop in output (c£15 million) although longer term this sector is expected to experience stronger growth with the drivers been electricity, rail and road.

Favourable population dynamics and improving consumer finances should continue to drive housing demand.

Construction activity continues to fall according to the IHS Markit / CIPS UK Construction Total Activity Index. There were substantial falls in all categories of work including commercial, civil engineering and housebuilding with the main cause being identified as 'Brexit uncertainty and the resulting aversion to risk and consequent delayed starts to projects. Despite the gloomy statistics, firms taking part in the survey were 'mildly optimistic' that output volumes would pick up in the coming 12 months.



The Experian total activity index fell into negative territory in August 2019. There were falls in both the residential and non-residential indices although the civil engineering index remained in positive territory.

The Construction Products Association has revised downwards its output forecast for the next three years due to concerns about the future of major infrastructure projects under a government led by Boris Johnson. The HS2 project, with a current anticipated cost of c£100bn, is the subject of a wide ranging review which is due to be completed this Autumn and question marks still remain over HS3 and the Heathrow expansion plans. The CPA said that if major projects were canned, then total construction output would fall by 1.7% in 2019 and experience no growth at all in 2020 or 2021.

The Construction Purchasing Manager's Index for September 2019 showed business confidence was at its lowest level since the global financial crisis of 2008/09.

**Quarterly and monthly all work index, chained volume measure, seasonally adjusted, Great Britain, June 2014 to August 2019**

Index 2016 = 100

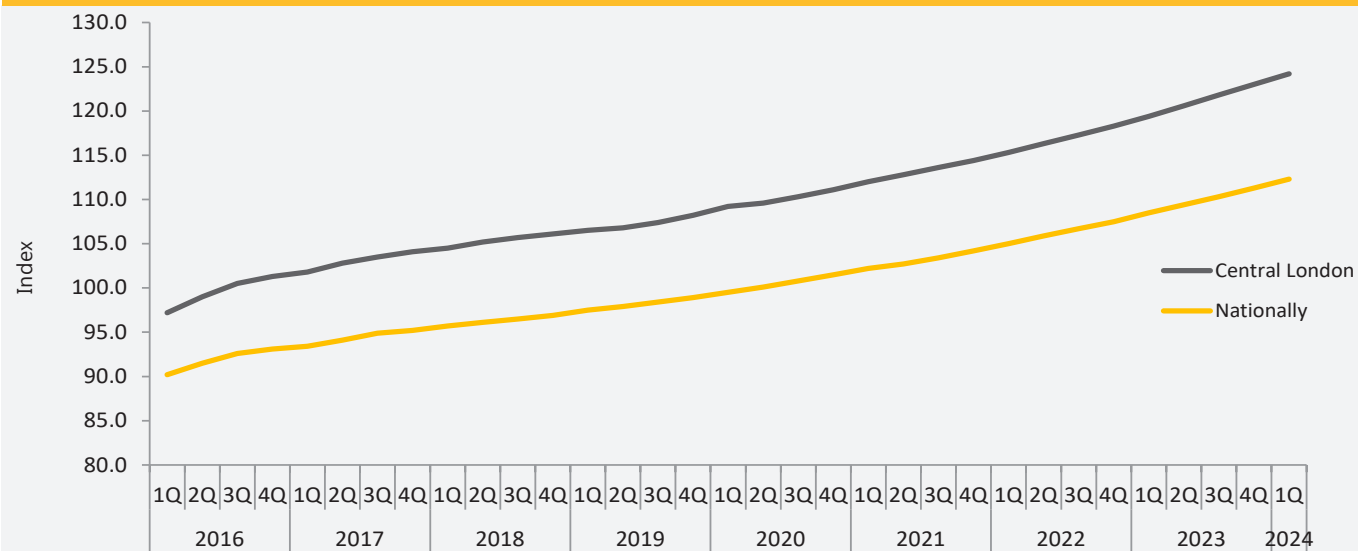


*Currently the Construction Products Association is predicting a 0.3% decline in total construction output for 2019, but its forecasts for 2020 and 2021 have revised down to a growth of 1% and 1.4% respectively.*





## WT Partnership - Tender Price Inflation Trends



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 2.2% in 2019, 2.7% in 2020 and 3.0% in 2021. For the remainder of the UK, tender prices are forecast to rise by 2.1% in 2019, 2.7% in 2020 and 2.7% in 2021.

The political situation in the United Kingdom remains very volatile and demand for projects and input costs are very dependent on the political environment. A smooth and positive Brexit that provides much needed certainty for the UK's economy could usher in an anticipated 'post-Brexit bounce'. Projects, currently on hold, would move forward in this scenario as business confidence increases with a likely further increase in tender price inflation.

Conversely, if the UK leaves the EU without a deal on 31st October 2019, then we could see tender price inflation falling due to lower demand and a more competitive market.

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.

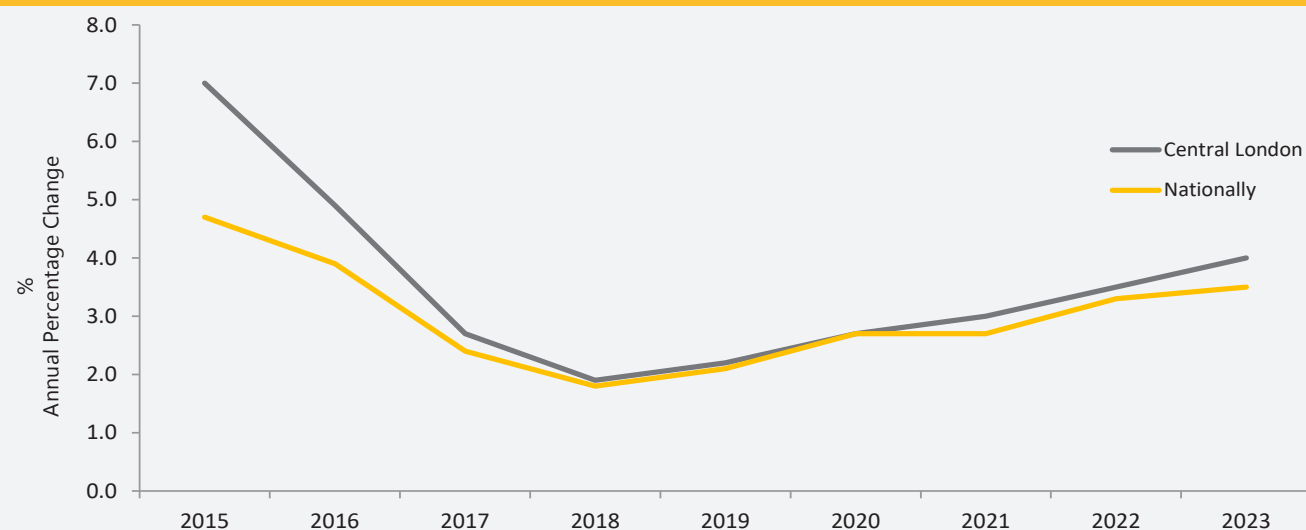
There is pressure on trade margins, trade margins are low while main contractor's overheads and profit are holding suggesting that trades are being squeezed, which is not sustainable. With margins tight, any increase in materials/commodity prices will affect tender prices or delivery.

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. Whilst we are not expecting OHP to reduce much, as margins are already tight, preliminaries could be subject to inflationary pressure with higher labour costs and having to adopt new construction technologies.

We are finding that tenders received for larger projects (£50M+), with the smaller pool of Contractors and greater risk profile, are generally in line with our tender price projections. There seems to be a greater degree of pricing hunger and appetite for projects at the sub £50M pricing level, which is partly due to the larger number of Contractors who are prepared to submit tenders.

## WT Partnership - Tender Price Inflation Forecast





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 decline in construction output, single stage tendering is becoming more prevalent with Contractors' having an increased appetite to take on additional commercial risk. 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.

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.

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.

Contractors want to secure projects that are likely to go ahead, have the right time-scales and budget in place and ideally involve a client they have already worked well with.

*There is increased competitive tension in the market with Contractors now actively looking to fill their order books for 2020 and beyond, especially at tier 2 level. This is particularly acute for the period going into 2021 where the pipeline of work is a lot less certain.*







### Unemployment

Unemployment rose by 22,000 to 1.3 million (3.9%) in the three months to August 2019 as the UK jobs market began to show the strain of uncertainty surrounding Brexit and the future of the global economy.



### Inflation

Inflation as measured by the Consumer Prices Index was 1.7% in August 2019, down from 2.0% in July 2019. This is still running at a very low level but a 'no-deal' Brexit and further falls in the pound could push it higher.



### 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. It is anticipated that, without a deal in place, the BoE will cut interest rates to support the economy.



### Brent crude oil prices

Brent crude oil was priced at \$59.30/barrel in October 2019. More recently crude oil price rises have slowed, despite tensions between Saudi Arabia and Iran, due to the market been well supplied with lots of oil in storage.



### Gross domestic product

Gross domestic product shrank by 0.2% in 2nd Qtr 2019 although it recovered in July 2019, rising by 0.3%. Construction, along with manufacturing, is acting as a drag on GDP growth. Experian have opined that they expect 2019 to be the weakest year since the 2008 recession in GDP growth terms. However, economists are now predicting that the UK will avoid a technical recession in the short term.



### Sterling

Sterling has fallen against the dollar to levels last reached in 1985, raising the cost of imports and prices for consumers. The Bank of England expects the pound to weaken further and growth to slow in the event of a disruptive Brexit.



### Public sector net borrowing (PSNB)

Public sector net borrowing (PSNB) in the current financial year to date was £31.2 billion, up 28% from the same period in 2018.



### UK average house prices

UK average house prices from Land Registry data is £234,853 as at August 2019 and has risen by 1.3% compared to the previous year.

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 100 after an initial post-Brexit fall has been steady and, as at October 2019, was 1,000 points higher than at the start of the year, potentially assisted by the fall in sterling making UK company stock a little cheaper for international investors.

20%

### VAT

Rate for the UK remains at 20%.



## Wage inflation

Average weekly earnings in the construction industry increased by 6.7% in the year to July 2019 to £653 per week, which is higher than the average weekly earnings for the whole economy which rose by 4.1% over the same period.

There remains a strong demand for skilled construction labour despite the fall in construction output which continues to have an inflationary effect on construction costs. Bricklayers and finishing trades have been particularly affected by the skilled labour shortage.

Skill shortages will become more acute if there is a 'no-deal' Brexit and sterling falls further in value as any potential labour will look beyond the UK in order to fulfil their earnings potential. Fewer people means wage inflation as those that still want to work in the UK realise that they are in short supply.

The CITB's Construction Skills Network forecasts that the construction industry would need to fill 410,000 jobs by 2030. This would need to be the focus of any future government's immigration policy together with introducing measures to increase skills and apprenticeships.

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.

## 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 and increasing tension in global trade relations generally. Steel and copper, in particular, have experienced significant pricing volatility over the last 12 months.

Inflation on construction material price has softened in recent months due to a slowing construction market and falling demand.

The 'All Work' construction material price index increased by 2.2% in the year to June 2019, according to latest ONS data. Since the EU referendum in June 2016 construction material prices have increased by approximately 13%, largely due to the weak sterling which has raised the cost of imports.

Commodity prices such as oil have fallen adding to the downward cost pressure. Tender pricing for external cladding and MEP services is increasing at a higher rate than other trades, largely due to a significant proportion of the materials being sourced outside the UK.

Concerns have been expressed that the cost and availability of cladding imported from Europe is likely to be affected by insurance hikes in the event of a no-deal Brexit. The larger European cladding companies can currently obtain PI cover through a parent policy from abroad, but in the event of a 'no-deal' Brexit this may not be possible as the freedom of services under EU policies would no longer apply.





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