

# UK MARKET VIEW

UKRAINE CRISIS WILL  
PUSH UP TENDER PRICES



Q1 2022



**Matt Fitzgerald**  
Commercial Director, Cost Consultancy

“Construction orders look strong as we go through the first quarter of 2022 however this growth is likely to be tempered by geopolitical factors driving rising oil and gas prices. This, combined with inflation, interest rate and taxation rises will put pressure of the cost of living, the cost of borrowing and construction costs which in turn may translate into a slowing of growth in the economy over the medium term.”



	2021	2022	2023	2024	2025
National	7.5%	5.5%	3.5%	3.0%	3.0%
London	7.5%	5.5%	3.5%	3.0%	3.0%

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.

↑ **The Bank of England has raised interest rates to...**  
**0.5%**  
and further increases look likely

↑ **Oil prices passed...**  
**US\$100**  
per barrel for the first time since 2014

↑ **Regular construction pay was just...**  
**2.1%**  
higher at the end of 2021 than a year earlier, but the risk remains earnings growth will start to accelerate

↑ **New orders jumped...**  
**9.2%**  
in Q4 2021, while private industrial had a particularly strong year

↓ **Construction output finished last year still...**  
**2.3%**  
short of the level it was in the final quarter of 2019

# SETTING THE SCENE

In our first Market View of the year, and with the majority of data for 2021 now available, we have come to the conclusion that tender prices rose 7.5% last year. This decision is based not only on Government published statistics but also on information from the Mace Construction supply chain. Unsurprisingly, having surveyed a wide variety of subcontractors covering the majority of packages involved in a typical building, there was a diverse set of responses. An important caveat to our tender price figures is that they are an average and the costs for different projects will inflate at different rates. More than ever this caveat was appropriate last year, and the spread of the change in tender prices from our supply chain reflects this. From a handful of packages where there was no increase to others where the prices of particular components spiked more than 40%, the range was extreme. However, overall, we believe an average increase of 7.5% is appropriate. We provide more detail about what happened last year, focusing on materials, labour costs and output in the first part of this report.

Successfully navigating last year's material price movements, which finished the year over 20% higher than 12 months earlier, will have been a challenge. For some, added to other difficulties linked to Covid-19, it will have been too much, and insolvencies, which Government support had helped limit, will rise. We discuss this as well as what else this year might hold in the second part of the report. Once again, price rises are likely to be a major problem. Worryingly, US lumber prices, which had eased, have been rising again and global supply chain problems have barely eased. Moreover, gas prices rose substantially in the second half of last year and Russia's invasion of Ukraine temporarily pushed Brent Crude oil prices over the price of US\$120 per barrel. This will hurt energy intensive products such as bricks, plasterboard and glass, and given transport is an important component in numerous products, oil having risen so substantially since the start of the year will lead to more widespread worries. Russia

is also a major producer of a number of key raw metals, including aluminium and copper alongside iron ore and lithium. We have therefore pushed up our tender price forecasts for this year to 5.5%.

Another area of geopolitical concern for the UK construction industry comes from Chinese developers. Evergrande, the world's most indebted property developer defaulted on its debt in December and is now in a restructuring process. Furthermore, work has essentially stopped at a £900m project in Battersea due to problems with a second Chinese developer. Chinese investment has long been key, particularly in London, and with little chance of other countries replacing this flow of money, the number of new projects may suffer. Alongside the strong likelihood of lower investment from China, there is also a tail risk of a more significant downturn. It is estimated that real estate accounts for around 30% of Chinese GDP and if the problems facing Evergrande spread out, dragging down Chinese growth and seeing other developers default and fail, there is the potential of more serious global repercussions. Nonetheless, there is a more benign scenario of slowing Chinese growth from a struggling real estate sector in terms of UK construction. In this case, weaker demand for materials would result in lower prices and moreover, the ongoing supply chain problems would resolve themselves more quickly.

Our final section takes a slightly more long-term view and looks at some of the issues the industry needs to be aware of as we move towards another general election and the mid-point of the decade. Government action, always a key component in analysing the industry, will stay of paramount importance and the upcoming Budget is likely to involve some difficult decisions. Notably, while there may be a desire to tighten fiscal policy, wider economic growth also looks set to slow in the coming years. Rising prices will lead to consumers cutting back, which in turn could hurt the residential part of the construction industry, both new build and repair and maintenance, as well as bits of the commercial market. The Bank of England has a difficult balancing act in trying to keep inflation under control while not denting growth. For the time being, our longer-term forecasts are unchanged, but if growth slows more than expected, we may need to revise them down.

# THE PAST: EXTRAORDINARY PRICE RISES

## Material prices

The only place to start when discussing the changes in 2021 is material prices. From the final quarter in 2020 to the last three months in 2021, the 'all work construction material price index' rose 22.9%. Throughout last year we were revising up our tender price forecasts as a result of higher material prices and their impact is the main reason why we've settled on our 2021 number. Particularly over the summer, the pick-up in material prices was spectacular. Between May and August, the average month-on-month rise was 2.6%, greater than often occurs over the course of a year.

That CPI inflation finished 2021 at 5.4% shows surging prices are not unique to construction, albeit they do appear to be at a different order of magnitude. Across the board, demand has rebounded far faster than supply. Issues with manufacturers getting back up to speed and shipping help explain much of the shift. In addition, soaring prices in two key construction materials have significantly influenced the overall index. Relative to December 2020, both rebar and fabricated structural steel had risen by over 50% and there were similar increases in a variety of timber products. While the detail behind these changes is specific to the materials, the main driver is demand far outstripping supply.

## Labour

Despite vacancies hitting record highs, employers managed to keep construction pay under control last year. Peaking at 46,000 in the three months to October, vacancies were over 75% higher than on average in 2019. At such levels it would not be unreasonable to expect earnings to escalate but by the end of the year, total pay was only 2.4% higher than in Q4 2020. Pay growth hitting 14.4% in June was due to the impact of furlough and

pay cuts from a year earlier meaning it is highly misleading. Relative to the final quarter of 2019, construction pay has grown 4.5%, significantly lower than the 9.1% average rise across the whole economy, and only the manufacturing sector has fared worse.

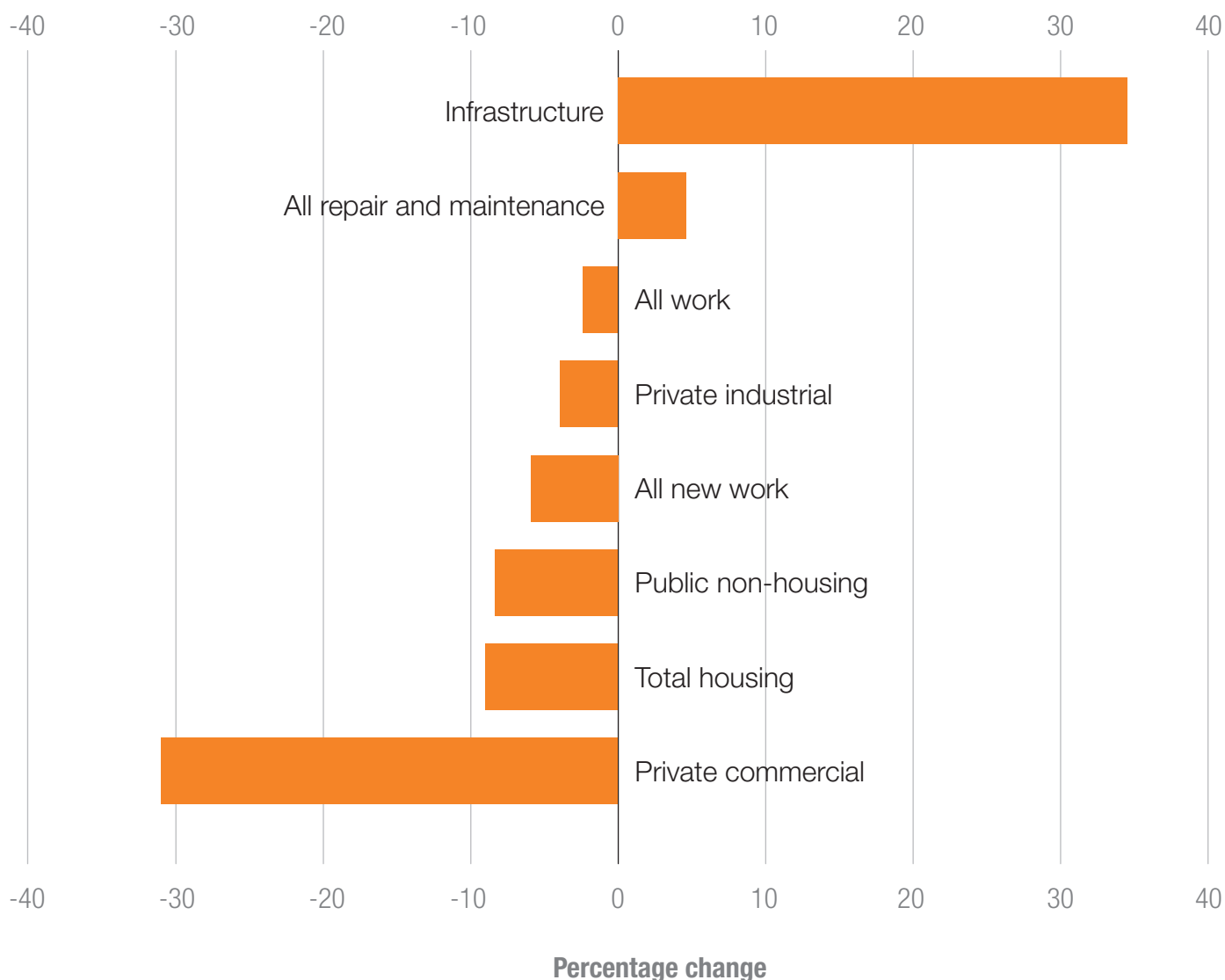
Firms have been watching regular pay even more carefully. As well as the data showing several months where bonuses were large, surveys have reported employers using one-off payments to retain staff. If vacancies normalise, using such incentives will have helped keep a lid on staff costs. Regular pay growth in 2021 was just 2.1% and a key question for construction and the Bank of England, is whether wages do start to spiral. For both, part of this answer is likely to depend on what happens to inactivity. In September 2021, there were 105,000 fewer jobs in construction than at the end of 2019. Persuading those who may have lost jobs to return to the industry will help curb pay growth.

## Output

While construction finished 2021 with robust growth in November and December, output growth for the full year was moderately disappointing. Overall, the industry grew 12.7% last year, but nonetheless, by Q4 2021 it remained 2.3% smaller than in Q4 2019. The only sectors in which output was greater than the final quarter before the pandemic were infrastructure and those covering repair and maintenance. Infrastructure, where output was 30.4% higher than in 2020 was also the only sector experiencing rising output in each of the four quarters. Helped in particular by roads and HS2, this highlights how the year has been far from smooth sailing for the majority of sectors.

Material shortages will have affected all parts of the industry last year, with smaller builders bearing the brunt of these problems. The stamp duty holiday looks to have supported housing output at the start of the year, and then following its initially proposed conclusion in March, the sector struggled. By contrast, private industrial had a difficult start to 2021 but from July onwards enjoyed record growth. Strengthened by new logistics centres and warehouses, industrial output grew 24% in the second half of the year. However, for one sector, 2021 was another year to forget. Private commercial was the only one where output shrank, as office fit outs failed to overcome the issues facing new builds and the retail sector.

**OUTPUT**  
Q4 2019 – Q4 2021



# THE PRESENT: NO LET-UP TO CHALLENGES

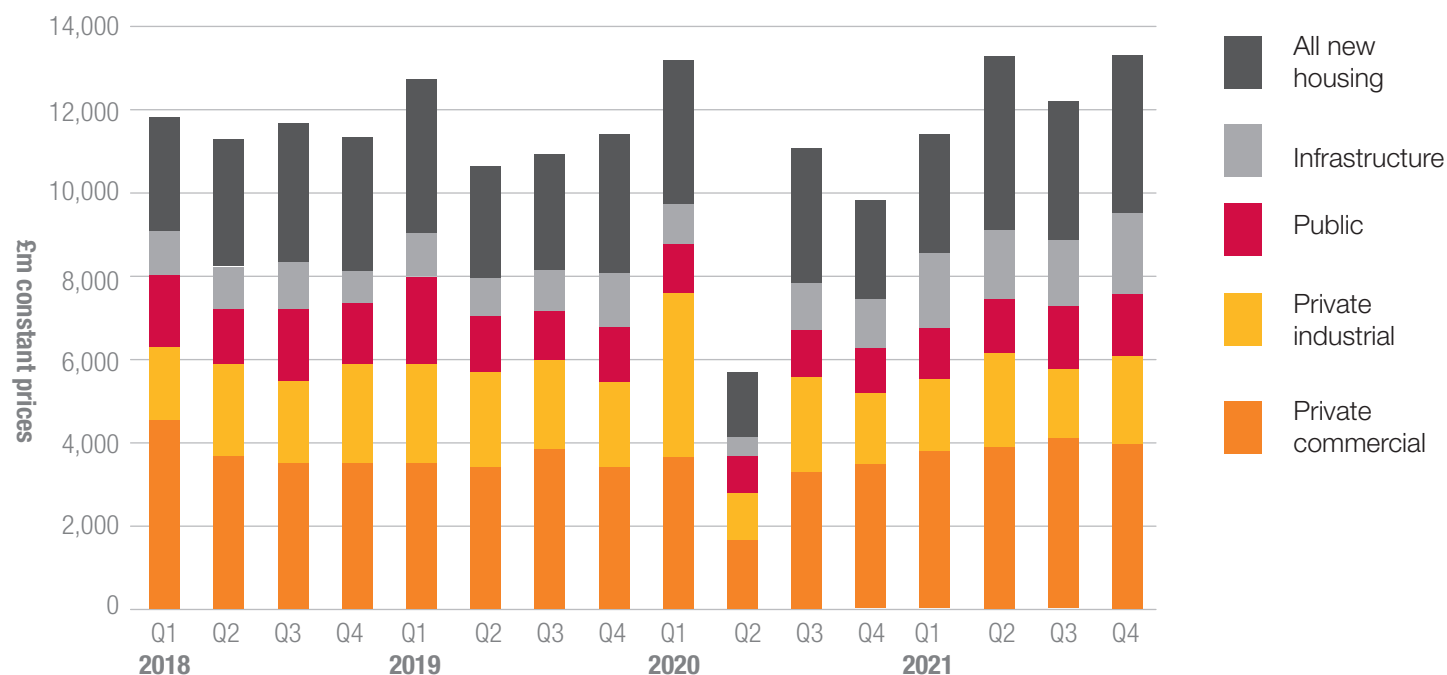
## New Orders

After a strong final quarter for new orders, the outlook for construction in 2022, based purely on these figures, looks good. Overall, new orders were 26% higher last year than in 2020 and also almost 10% larger than in 2019. Importantly, given the current overreliance on the infrastructure sector, new orders excluding this category were at a record high since 2008. For the industry to experience more sustained and reliable growth, it needs more than just one sector to step up. While a relatively small sector, private industrial is one where output is already rising rapidly and another impressive new orders figure in Q4 means this trend should continue. As well as warehouses, a rebound in factory orders, notably in the final quarter, meant it was the sector's best year for a quarter of a century.

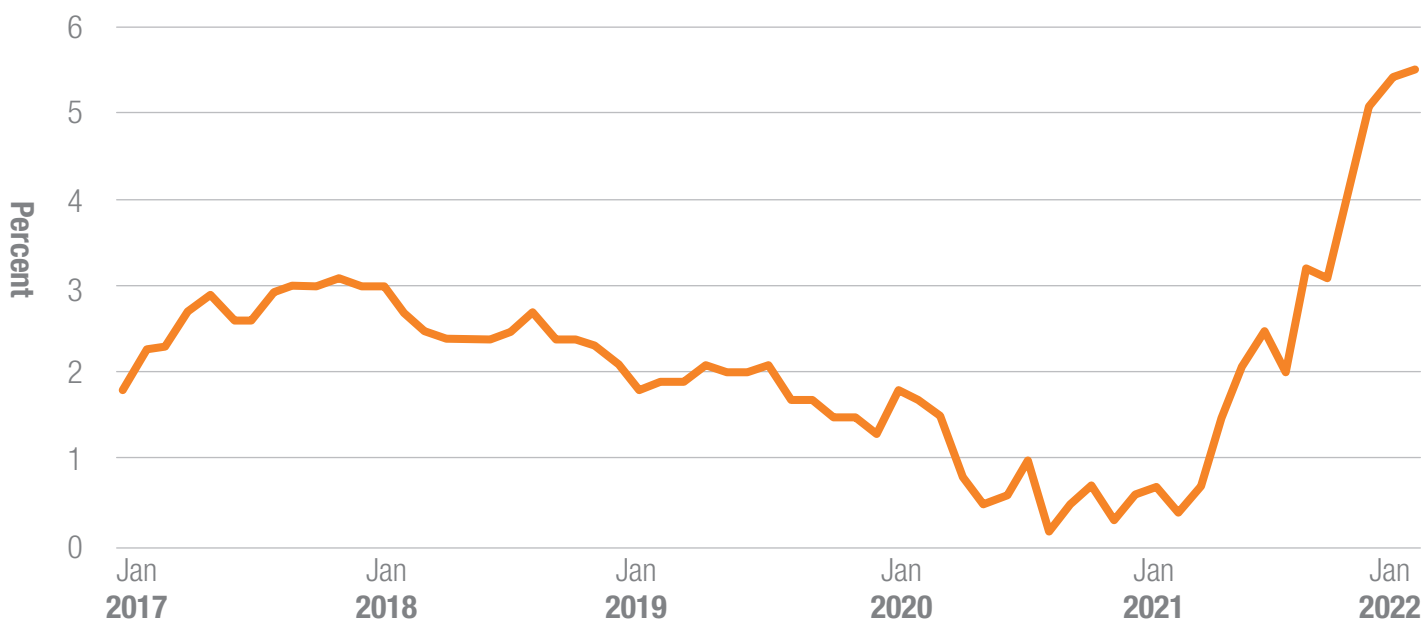
Public non-housing, private commercial and infrastructure also all grew at the end of last year. For public non-housing, it was the health sector providing the biggest fillip adding to robust education figures from earlier in the year. Yet overall, in 2021, the sector was lower than in 2019 and output growth will remain modest. While in Q4, harbours had their best quarter ever and there were further large rail contracts, it was not enough to prevent infrastructure having its worst year since 2014. After such large output growth this year, and the guaranteed pipeline from previous years, moderate new orders in 2021 are not of concern. Commercial's new orders were up a third compared to 2020 and though it is the clear straggler in terms of output, this does mean there is considerable potential for catch-up this year.

Finally, while there was a small drop in housing new orders in Q4, 2021 was an outstanding year for the sector, its best since before the global financial crisis. House prices outstripping build cost inflation will have encouraged developers but as we discuss in our next section, there are a number of headwinds which could hold back output. In addition, there has recently been a clear disconnect between new orders and housing starts. Whereas new orders peaked in Q3, starts were slumping. Potentially indicating a delay to getting projects onto site, it will need to reverse if housing output is to continue to recover.

## NEW ORDERS



## CPI INFLATION

**Cost of Living Crisis**

As we discussed at length in our last report, interest rates will be rising this year. Following their decision in December to raise rates to 0.25%, the Monetary Policy Committee increased them again at their meeting in February. Interest rates now stand at 0.5% and further upwards moves look inevitable later in the year as the Bank tries to control inflation. This will affect both developers looking to finance schemes as well as consumers taking out mortgages. With almost three-quarters of mortgages currently fixed, the increases won't have an immediate impact, but it is one of a number of factors which will hurt households this year. A repeat of last year's rampant house price growth, when prices jumped by more than 10%, is almost inconceivable. In turn, a cooling market may put off developers and the strong residential new orders numbers won't necessarily feed through into output. In addition to new builds, the repair and maintenance sector could also face a downturn. Private housing repair and maintenance is the second-best performing sector since the pandemic but has slowed in recent months and will face difficulties if households tighten their belts.

Unfortunately, consumers are likely to cut back spending this year due to rising inflation. Already noticeably higher than wage growth, it is forecast to top 7% in April and would mean that prices would be rising at their fastest rate since 1992.

April is when Ofgem's energy price cap is due to rise 54% and the price of oil is at its highest in over seven years. Added to this is the lack of let-up in supply chain problems and the widespread pressures these have caused. With oil prices having risen considerably since the Bank of England produced this forecast, inflation is likely to come in even higher.

One final factor that will mean some of the population have less to spend is a planned 1.5% increase in National Insurance. While this won't affect pensioners and those whose income derives from dividends, for most in work it will mean lower take home pay. Moreover, the rise in National Insurance also applies to employers. As such, not only will they have to manage employees experiencing a cut in their real pay due to inflation and lower pay because of National Insurance, but their own costs will be going up as well. This may limit their potential to give pay increases and the Bank of England has encouraged restraint in order to prevent a wage-price spiral. However, this restraint is easier said than done. Vacancies are at record highs for the whole economy, and while they have eased in construction, they are still well above typical levels. In such a market, keeping a lid on wages is unlikely to be straightforward.

## Impact of war

While it is still far too early to determine the full effect of Russia's invasion of the Ukraine, a few things are clear. Firstly, the UK imports few construction products from either country with one estimate of just 1.25% of imports coming from the region and these can be sourced from elsewhere. However, the more significant problem will come from higher energy prices and the knock-on effects of other countries dependent on Russian or Ukrainian goods.

Petrol prices are now at their highest level ever, although in recent days the price of oil has eased. Higher transport costs will push up material prices, while sites where diesel is still in use will also face additional inflationary pressures. Additionally, materials which use petrochemicals, such as plastics and bitumen, will go up. Similarly, although gas prices have come off from their peak, they are still at highly elevated levels, as are electricity costs for industrial users. One example of the impact this will have on energy intensive products, is British Steel's announcement that they would be increasing prices by £250 per tonne.

What happens as a result of these price rises is also of deep concern. For some, rising construction costs will make new schemes unviable. Following 2021's extraordinary rise in tender prices, another year of significant pressures is likely to force various developers into cancelling new schemes. It may not be until the second half of the year that the level of demand destruction becomes more apparent, but it now seems almost certain that some jobs which were previously feasible are cancelled or put on hold.

The impact on the wider economy will also be severe. The cost-of-living crisis just discussed will only worsen and economists are bringing down their GDP forecasts. If the Bank of England responds to higher inflation with higher interest rates, it would have a detrimental effect on construction projects requiring cheap finance and potentially house prices. Alternatively, the Bank may believe higher inflation is going to lead to a faster slowdown in growth, and it is possible that we will see fewer interest rate rises this year and next, than was previously anticipated.

## Insolvencies

Ever since the start of the pandemic, insolvencies and companies failing have been a risk and something we have highlighted a number of times. Initially, the fear was lockdown and work on sites stopping would push companies to the wall. However, government support both through the furlough scheme and various schemes for business prevented this. Total insolvencies in 2020 were their lowest since records started in 2011 and even following a rise last year, they were still short of any figure seen in the previous decade. That construction got to reopen earlier than many sectors, helped reduce its share of insolvencies from an average of a bit over 18% to 16% in 2020.

More recently, at the same time as government support came to an end, rising input costs and lengthening lead times have created a situation where a project's profitability could be coming under severe pressure. This is likely to be a particular problem with fixed price projects, but the speed with which material prices have accelerated will have caught out numerous contractors. A Bank of England survey acknowledged the difficulty in which construction firms have found passing on costs on existing projects. The clearest example of these problems is Midas Group, an almost £300m turnover company falling into administration. It is unlikely to be the last high-profile casualty of the year.

The advice for consultants in dealing with this risk is unchanged; make sure a thorough due diligence on all contractors takes place and have a strong understanding of the entire supply chain. In addition, while it may be tempting to accept the lowest price bids, if the firms submitting them are in a precarious position, desperate to win work, it could end up damaging the project. Consultants will also need to be aware of any Russian companies involved in the supply chain and have plans for how to deal with them. In both cases, the Construction Playbook contains useful advice in particular the sections on early supply chain engagement, assessing the economic and financial standing of suppliers and resolution planning.



# THE FUTURE: GROWTH TO EASE AS RESULT OF HIGHER PRICES AND RISING INTEREST RATES

## Slowing growth

While managing the challenges of this year is daunting, slightly further ahead may only be marginally easier. In particular, the medium-term forecasts are for weaker growth. Data from the Treasury's Forecasts for the UK economy: a comparison of independent forecasts, shows that GDP growth will fall to 1.6% in 2024 and remain at that level in both 2025 and 2026. These forecasts were produced before the Ukraine crisis and appear likely to be downgraded. Even so, they are still below the average growth rate in the 2010s, a decade beset by impediments such as austerity and Brexit negotiations. Were the economy to end up in this low growth environment, it is easy to imagine that the residential and commercial parts of the construction industry in particular would struggle.

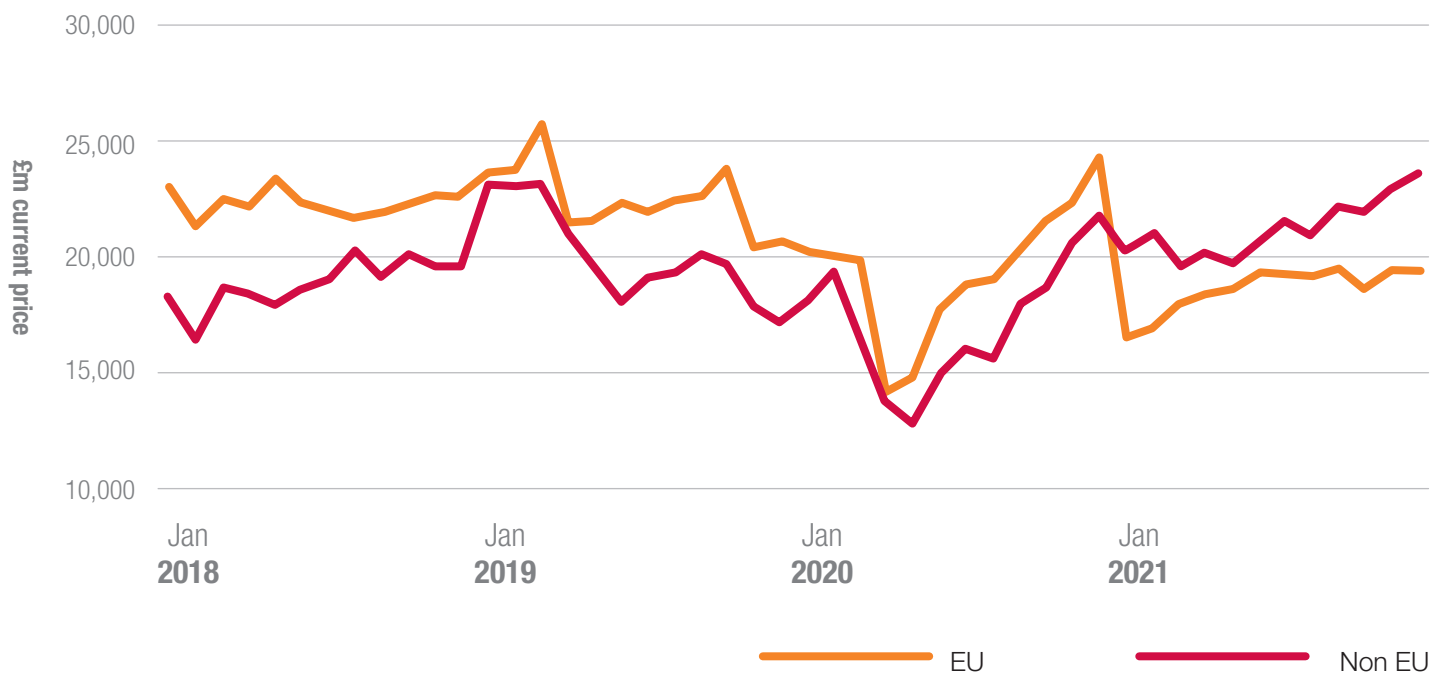
It is not only independent forecasters who anticipate slowing growth. The Bank of England believes that higher inflation will lead to rising unemployment. Finishing 2021 at 4.1%, the Bank expects it to continue to drop at the start of this year, falling to 3.8%. However, by Q1 2023, it will have risen to 4.2% and by the first quarter in 2025, it is forecast to have steadily risen to 5%. The rising price of goods and the cost of living crisis will stunt growth and push up unemployment. In an alternative scenario, where interest rates are left at their current level of 0.5%, then the Bank predicts unemployment would also stay roughly at where it is currently. This highlights one of the risks facing policymakers in Threadneedle Street, and only further complicated by the war: if they raise interest rates too quickly, they could throttle a still fragile economy.

## Brexit rumbles on

The transition period of the UK leaving the EU may have ended in January 2021 but that does not mean the issue of Brexit is over. Firstly, in January 2021, there was a large drop in imports which has not yet recovered. With around a quarter of all construction products imported, this downturn will have inevitably created some complications. While the overall split between EU and non-EU has recently turned and there is now a slightly larger share coming from further afield, for construction materials it has typically been closer to 60/40 in the EU's favour. With full import declarations now having to be made, even more hurdles exist for importers.

On 1 January next year, there is also another big change due to come into effect. The start of 2023 is when the new UKCA mark is set to replace the existing EU CE mark. Used to designate that products are legal and have gone through the appropriate testing process, this switch has already been pushed back. Yet, delaying the change by a year has merely kicked the can down the road and the fundamental problem of not having enough testing sites to recertify every appropriate construction product persists. Testing is both costly and lengthy and another delay is probably necessary to avoid significant problems next year. However, even if this occurs, short of abandoning UKCA, which the Government insists is not an option, once the new regime does come in, it will almost certainly be both inflationary and result in fewer products available.

## IMPORTS



### Limited potential for new government help

The next Spring Statement is due to take place on 23 March and as usual it has the potential to make or break some in the industry's plans. For the Chancellor of the Exchequer, Rishi Sunak, the good news is that in the ten months of the financial year to January, borrowing was £17.7bn lower than the Office for Budget Responsibility had forecast. This may give him scope to help ease the inflation burden. However, there is also less positive news which is that due to rising inflation and higher interest rates, borrowing costs are set to increase. What this means for construction, which is already benefiting from several large infrastructure schemes as well as the Levelling Up and Towns Fund alongside promised spending for education and healthcare, is that significant new funding is unlikely.

Ever since the Grenfell tragedy in June 2017, the Government has struggled to get to grips with combustible cladding. Determining who should take responsibility for past failures is not an easy topic, especially as those least able to pay, the leaseholders, are also those impacted the most. So far, the Government has already pledged over £5bn as part of its Building Safety Fund, albeit

the pay-out appears slow, and more recently they announced their intention to force developers to contribute a further £4bn. For those expected to pay, this means further headwinds to a market which, because of lower real pay and rising interest rates, may become much tougher over the next year or two. Share prices of housebuilders have fallen significantly since the turn of the year and while it is unlikely to noticeably reduce supply, it will mean the viability of some schemes are reassessed.

The Government could also help by choosing to delay the introduction of the red diesel ban. While this is an important move in the country's decarbonisation process, the timing of the change, at the start of April, is far from ideal. With diesel prices having surged over the past year, as the global economy has recovered and the Ukraine crisis started, contractors could do without this additional cost. Based on March prices, a government report indicated that the median fuel costs would almost triple.

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