

UK MARKET VIEW

MORE RECORD MATERIAL
PRICE GROWTH



Q2 2022



Matt Fitzgerald
Commercial Director, Cost Consultancy



We are seeing unprecedented near-term inflation, underpinned by price surges in oil, gas and key construction materials, this situation may turn more volatile if China's zero Covid policy stalls their economy and if anti-inflationary measures are applied too hard by central banks, this potential is making predicting near to medium term economic metrics very uncertain.



	2022	2023	2024	2025	2026
National	8.0%	4.5%	2.0%	2.0%	3.0%
London	8.0%	4.5%	2.0%	2.0%	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.

↑ **CPI inflation jumped to...**

9%

while a 5% month-on-month growth in material prices resulted in its annual rate of inflation almost hitting 25%.

↑ **As a result of rising prices, the Bank of England raised interest rates to...**

1%

in May.



Despite declining 2.6% in the first quarter, new orders were still...

13.4%

larger than a year ago.



Construction output had a strong start to the year, rising by...

3.8%

and taking the industry to a new record high.



Labour costs are starting to accelerate, but with regular pay growth at...

4.1%

real incomes are falling.

SETTING THE SCENE

Based on the recent increase in material prices, it is once again necessary for us to significantly revise up our tender price forecasts. This was a common theme of last year's reports as supply chain problems persisted, forcing material prices higher and higher. With China adopting a zero-Covid strategy, many of these issues look unlikely to fix themselves anytime soon. Adding to this is the terrible situation in Ukraine. In early March, at the time of our last publication, everyone was hoping there would be a swift resolution to the war, but unfortunately this has not occurred. It now seems likely that this to be a prolonged situation, adding to inflationary pressures.

So far, the war has triggered large movements in three vital products, most notably, oil, natural gas and steel. UK natural gas spot prices may have come down over the past month, but forward prices, used by many providers to hedge – and also the best indication of what is to come – are still elevated. Furthermore, many companies may have already bought much of their energy requirements for this year. Forterra, the brickmaker, and a company which has put up costs around 30% since January, report that they have done this. While it does remove volatility and uncertainty, it means they won't benefit from any fall in prices. Additionally, and partly due to these energy price rises, steel rocketed in March, with rebar increasing by over 30% in the month.

Overall, the construction material price index rose 5% in March and is now almost 25% higher than a year ago. With labour costs also starting to pick-up, we have no option but to increase our tender price forecast to 8%. One reason this number may prove too high is if China's problems get worse. Already, their lockdown has resulted in global iron, copper and aluminium prices slumping and if their economy weakens further, then it could lead to prices falling in the UK. It is also possible that the high level of inflation will either directly cause a recession through consumers cutting back, or indirectly, if the Bank of England raise interest rates

too aggressively. This is a considerable risk and may result in us having to reverse the increase in tender price forecasts for 2023.

Having seen substantial inflation last year, and possibly an even larger increase in prices this year, we look in depth as to why and how higher inflation will have an affect many years into the future. Large, lengthy projects, such as HS2 and Hinkley Point C will see their total costs rise substantially and new developments will find it tougher to get approval. Similarly, even where it is possible for a client to absorb the costs on one project, the number of schemes they take forward may dip due to higher inflation meaning reduced spending power. An example of this is that in the Spring Statement, the Government chose to keep many settlements to the levels agreed in last October's Spending Review. Without funds rising in-line with inflation, the number of projects that can be delivered will fall. As a result of these complications, and also due to the likelihood that material prices will come back down, we have revised down our forecasts for 2024 and 2025 to 2%.

There are also increasing downside risks to our forecasts. Not only could material prices fall much quicker than expected, but there is now a not insignificant possibility that the UK will fall into a recession next year. The Bank of England, which is forecasting that CPI inflation surpasses 10% later this year, before easing to 1.3% by the end of 2025, are now predicting that GDP will fall in 2023. While not actually meeting the technical definition of a recession, its latest forecast is for GDP to decline 0.25% over the year. This is much lower than other forecasters, who on average see GDP rising 1.3%, with none expecting a reduction. If the economy does weaken as much as the Bank anticipates, construction would undoubtedly slow down. This in turn would lead to contractors becoming more competitive with their prices as well as potentially putting renewed pressures on workers' pay.

WHAT THE LATEST NUMBERS MEAN FOR TENDER PRICES

Construction output

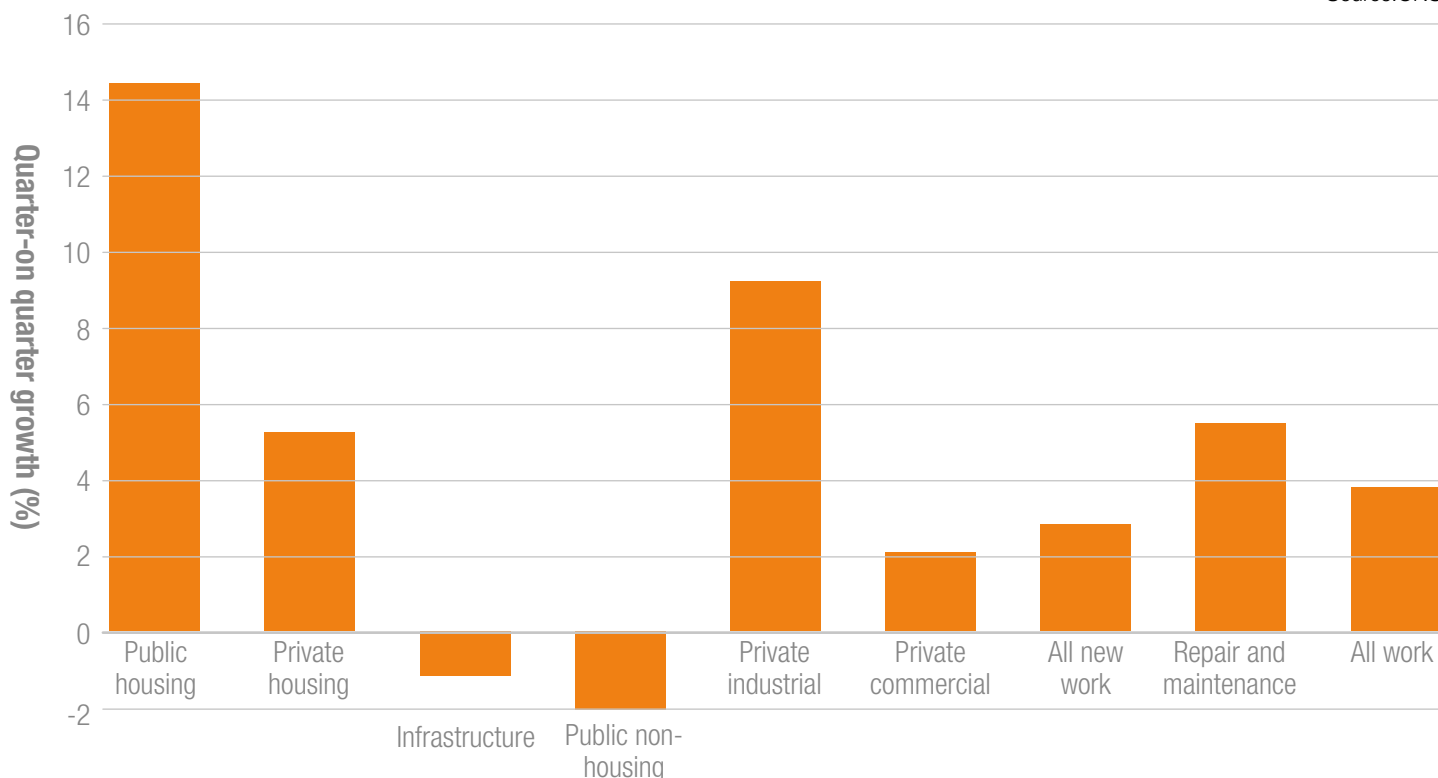
Overall, construction has had a very good start to 2022. Output grew 3.8% in the first quarter, pushing the size of the industry to a new high. Most sectors expanded with the fastest growth coming in private industrial, housing and repair and maintenance. Alongside a decline in public non-housing, infrastructure was the only other sector to shrink in Q1 yet despite this being the second quarter in a row where its output fell, it is still easily the best performing sector since the pandemic. Due to methodological changes, private housing is now larger than before Covid, but total housing output, even after Q1's 6.3% growth, is still down. This leaves only three sectors: private industrial, private housing repair and maintenance and non-housing repair and maintenance, as the sectors other than infrastructure where output is higher

than in Q4 2019. Whereas private commercial may have grown in the past two quarters, it is still over 25% smaller than it used to be. Also struggling is public non-housing. Here output declined 1.9% in Q1, leaving the sector almost 11.7% down relative to before the pandemic.

While the strong first quarter, alongside base effects, mean that the industry is almost certainly going to be larger this year than last, there is a good chance that growth will struggle over the coming months. New orders slipped 2.6% in Q1, hurt by a reduction in housing and private industrial. Additionally, and just as importantly, the three sections we discuss next: labour, material prices and interest rates, will all pose their own challenges to output expanding.

CONSTRUCTION OUTPUT GROWTH IN Q1

Source:ONS



Labour

In the first three months of the year, unemployment fell from 4.1% to 3.7%. However, while this is the lowest level since the 1970s, much of the reduction is due to a higher economic inactivity rate, and the employment rate remains well below pre-pandemic levels. Because of this, and another rise in the number of vacancies, there are now more jobs available than people unemployed. For construction, vacancies are also at record highs. This is starting to push up the rate of pay growth although it is not responding quite as vigorously to labour shortages as some sectors, such as retail and hospitality. Construction firms continue to use bonuses and one-off payments as a way of avoiding making long-term commitments. Whereas regular construction pay growth is 4.1%, total pay has risen 6.9% compared to the first quarter of last year.

That one-off payments are causing much of the growth, means not all of it is likely to feed through into current tender prices. However, our outlook is over five years, and the potential for substantially higher labour costs may exist for much of it. At the very least, until vacancies come back down to more normal levels, rapid pay growth will be a major risk. With much of the increase in inactivity across the whole economy coming from those aged over 50, a key category for the construction industry, it is possible vacancies will not come down anytime soon. There is also the problem with Brexit and immigrant labour that still needs solving.

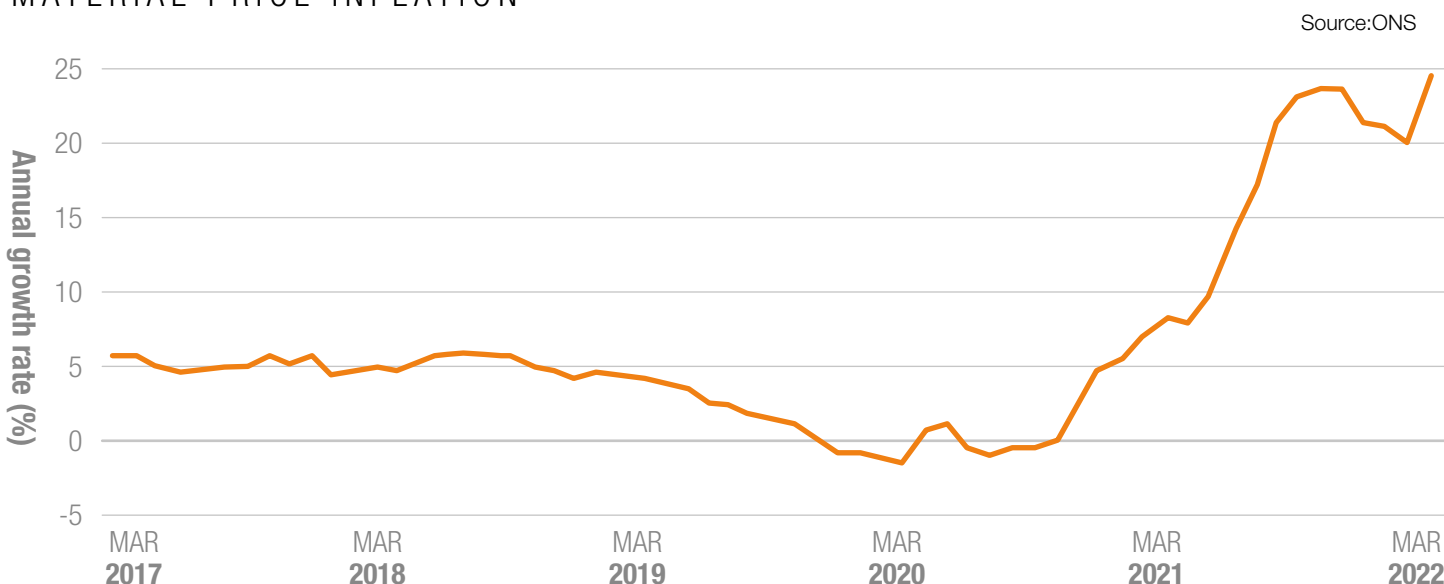
Finally, if the industry is to continue to grow, short of a complete change in the way schemes are built, more workers will be required.

Material prices

The war in Ukraine has resulted in material price inflation, which had shown some evidence that it was slowing, to ramp back up. In March, the 'all work construction material price index' rose 5% month-on-month. This is substantially higher than the previous monthly record of 3.8% hit last August, and pushed the annual rate of inflation to 24.5%. Steel products were the main reason that the overall index shot up so much in March, but even though other materials are not experiencing such staggering price increases, the inflationary pressures are still widespread. The Department for Business, Energy and Industrial Strategy, who produce the construction material price statistics, are reporting that 19 of the 29 products they cover have risen by more than 10% over the past year.

Having had another month where material price inflation has exceeded what one would expect in a reasonable year, it should come as no surprise that tender prices will see further significant rises this year. Only a global downturn, and admittedly the chances of this are growing, seems likely to fully take the heat out of a number of markets.

ALL WORK CONSTRUCTION MATERIAL PRICE INFLATION



Interest rates

In each of their last four meetings, the Monetary Policy Committee have raised interest rates. Starting from 0.1% in December, by the middle of May they had increased to 1%, and further rises are likely to follow. There may not be a direct relationship between interest rates and tender prices in the way material and labour costs drive inflation, but the changes are still highly relevant. For developers, higher borrowing costs, and the base rate is now its highest since the global financial crisis, will impact viability assessments. This could result in them offering less on land costs or needing to adjust the size of schemes accordingly. For construction firms, a recent survey by the Bank of England highlighted credit conditions were a challenge, and any who have borrowed on variable rates will be seeing repayment costs going up. Furthermore, refinancing or any new borrowing will also be more costly.

One of the Bank of England's biggest fears is about a wage-price spiral developing. In such a scenario, higher inflation would lead to employees asking for higher pay, which in turn would result in higher prices. So far, there is only modest evidence of this happening. While nominal regular pay growth is picking up, real pay is now 1.2% lower than a year ago. Assuming this doesn't occur, and inflation doesn't stay higher for longer, the Bank of England's latest forecasts were that inflation would peak at 10.2% in the final quarter of this year, before easing to 3.6% in Q4 2023, and falling to 1.3% at the end of 2025, well below its target.

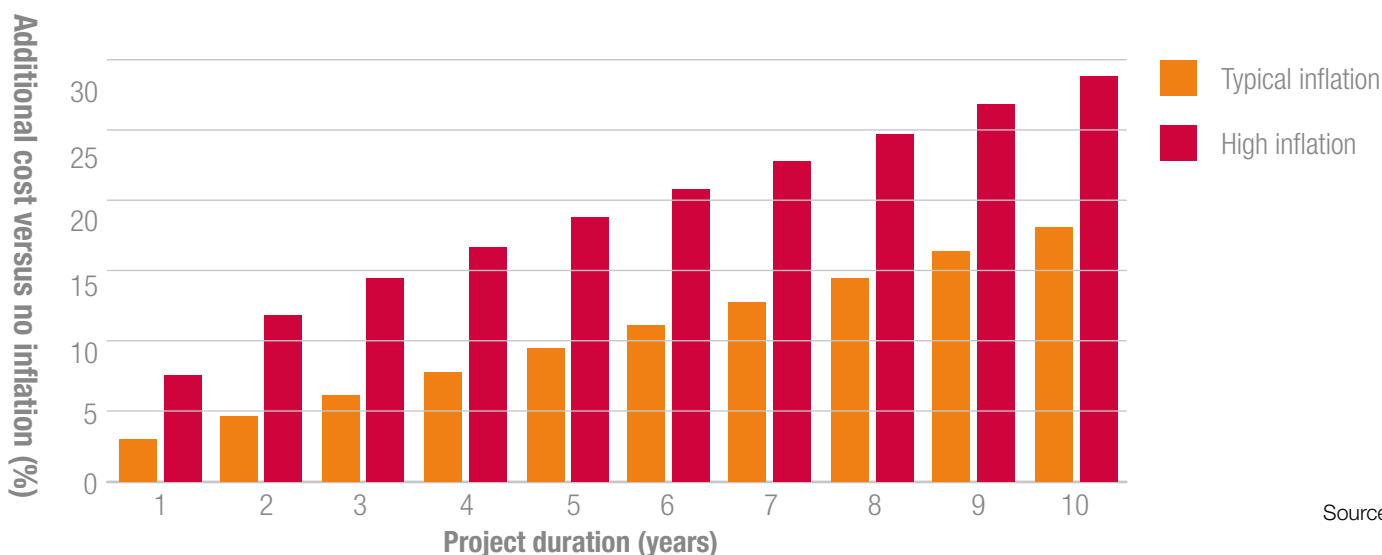
LONG-TERM IMPLICATIONS OF HIGHER INFLATION

For construction, the recent increase in inflation comes with both immediate and longer-term consequences. The short-term issues are well established. Most notably, fixed price projects are putting contractors, especially smaller sub-contractors on such schemes, who have fewer resources and flexibility, at high risk of losing money. In March, there were 419 construction insolvencies, over a third more than in the same month in 2019. This is likely to be a common theme this year as a combination of companies who have never fully recovered from problems created by Covid, in addition to those unable to deal with higher material costs, collapse. Furthermore, the current unprecedented material price increases create large amounts of uncertainty, that both clients and contractors may not want to deal with. For clients, this could lead to delaying projects, while any contractors having to bear the risk are likely to respond through supplementary increases in price.

However, even for long-term projects, where contracts allow for price fluctuations, there may be problems, if not for the contractor, then for the client. Inflation compounds, meaning that there is a link between current inflation rates and the price in the future. Short of deflation, higher prices now, mean higher prices later. This may sound straightforward, but it is incredibly important for

schemes which go on for many years, and such projects are likely to face noticeably higher costs than originally planned for. A prime example of this is HS2. With Phase One not due to finish until 2029 at the earliest and the second phase potentially going on for a decade more, short of a significant reversal in costs very soon, the current significant inflation levels will have far reaching effects. The scheme has already had elements downgraded and rising costs were recognised as a significant risk at a recent Public Accounts Committee hearing.

The following chart attempts to show the importance of compound inflation in a bit more detail. For simplification purposes, we assume a project where construction starts in year 1, having agreed the contract in year 0. We then look at scenarios where the project lasts anywhere between one and ten years, splitting the yearly spend evenly across each year. In the case of a typical inflation project, we assume that inflation in each year of the project is 3%. Importantly, in the first two years of the high inflation project, we assume that inflation is 7.5% in the first year and 8% in the second. This is what we believe tender price inflation was last year and our current forecast for this year. From then on, inflation falls back to 3%, so matches what happens in the typical inflation scenario.



Source: Mace

The graph shows how inflation adds to the costs of the project depending on how long the project lasts. For a project which lasts just two years, in the typical inflation scenario, inflation adds almost an extra 5%, whereas in the high inflation scenario, total costs will rise almost 12%. By contrast, in a 10-year project, the typical inflation scenario will see costs increase 18% but they will go up a bit below 30% in the high inflation scenario. It should be clear that the longer the project lasts, the more important inflation is. For a £1bn project, total costs under the high inflation scenario having gone up to £1.29bn are 9% higher than the in the typical inflation scenario. In the two-year project, total costs are only 7% higher (£1.12bn vs £1.05bn).

It needs to be remembered that this is for illustrative purposes only and inflation will be more volatile than these examples show. Similarly, in reality project costs are not spread evenly, and typically follow the shape of an S-curve. Nonetheless, however a project's programme proceeds, the higher inflation levels at the start will feed through many years down the line. Even were inflation to fall to 1% in each of the eight years following the high inflation period, total costs in a project this long, would still outstrip the typical inflation scenario. Also highlighting the unlikelihood of total costs returning back to previous levels, assuming no change to 3% inflation in later periods, prices would need to fall 7.3% next year for the 10-year project to have identical costs in both scenarios. It is possible to run all sorts of potential scenarios, but the main take away is that long-term projects are extremely sensitive to inflation at the start and with last year and this year being so high, it will be difficult to get back to where we were.

It is also not only existing projects which will be affected. Planned schemes, that may not be due to start until the middle of the decade will also encounter challenges. With the costs of these projects having gone up, clients will need returns to rise proportionally. This could be a particular problem for offices, with hybrid working changing demand, as well as retail, and the ongoing challenges shops face. Additionally, annual house price growth is starting to slow. While falling from 11.3% in February to 9.8% in March isn't a problem for developers, the cost of living crisis may lead to a more pronounced slowdown. Combined with higher costs, this could trigger a pullback in the market several years down the line. A second problem is that higher inflation is pushing up interest rates, and in theory this means hurdle rates in viability assessments should go up. If hurdle rates do go up, then new developments will find it tougher to get approval.

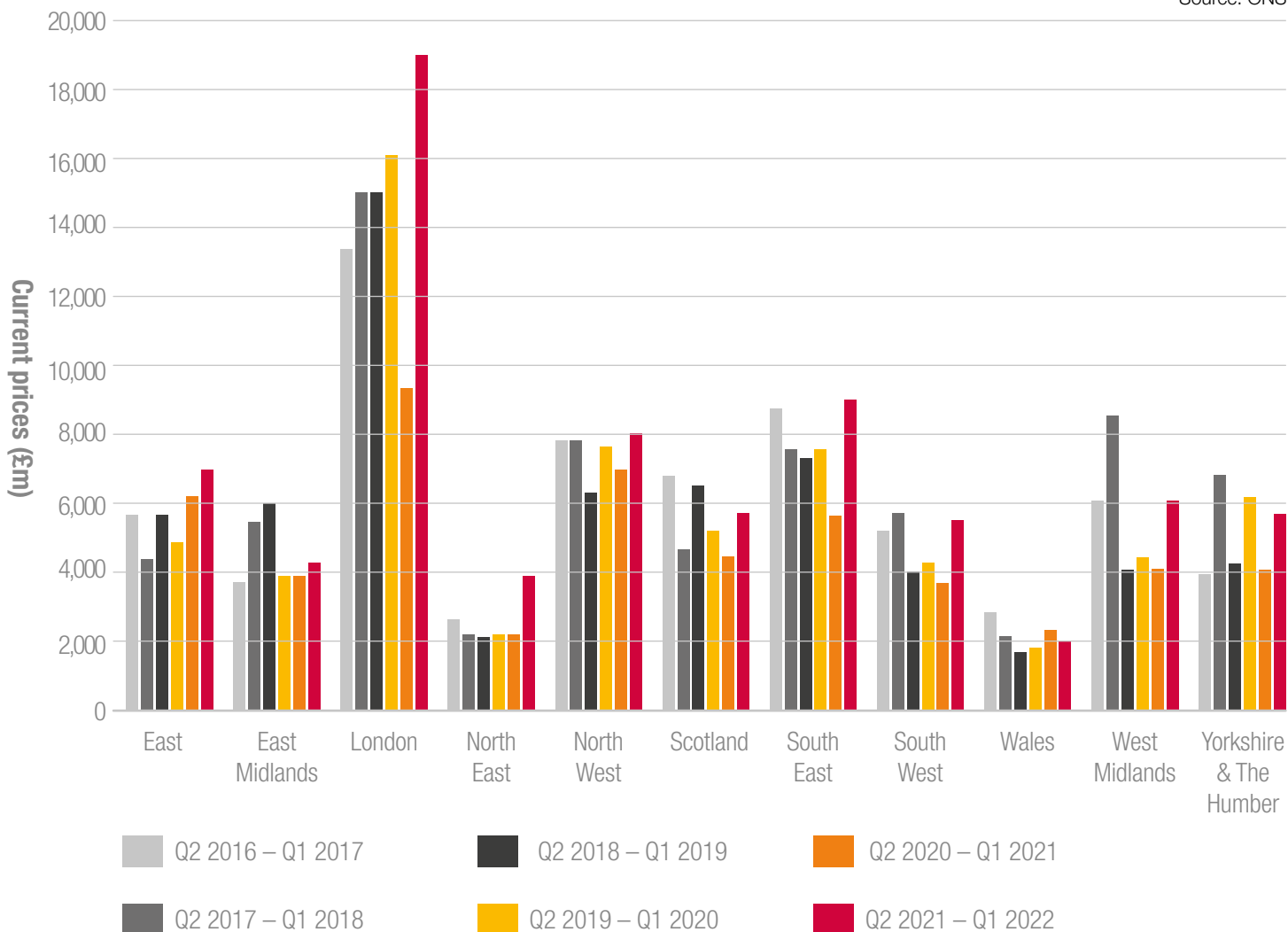
HOW ARE THE UK REGIONS PERFORMING?

One of the central aims of the current Conservative government is its “levelling up” agenda. If successful, this will reduce inequalities between different regions, with poorer areas enjoying faster growth and narrowing the gap with London and the South East. The Government’s recent Levelling Up and Regeneration Bill aims to achieve this through greater devolution and improving the planning process. Clearly it is too early for this Bill to have any effect, but construction can be a good guide as to whether any shift based on previous policies is taking place.

This is true both because it is one of the key sectors that will help with levelling up, particularly through infrastructure projects, and also, if levelling up is actually taking place, there will be greater demand for houses and offices. However, the latest set of new order numbers show that London has had one of its best ever quarters and that there has been little growth in many of the regions over the past few years.

TOTAL NEW ORDERS

Source: ONS

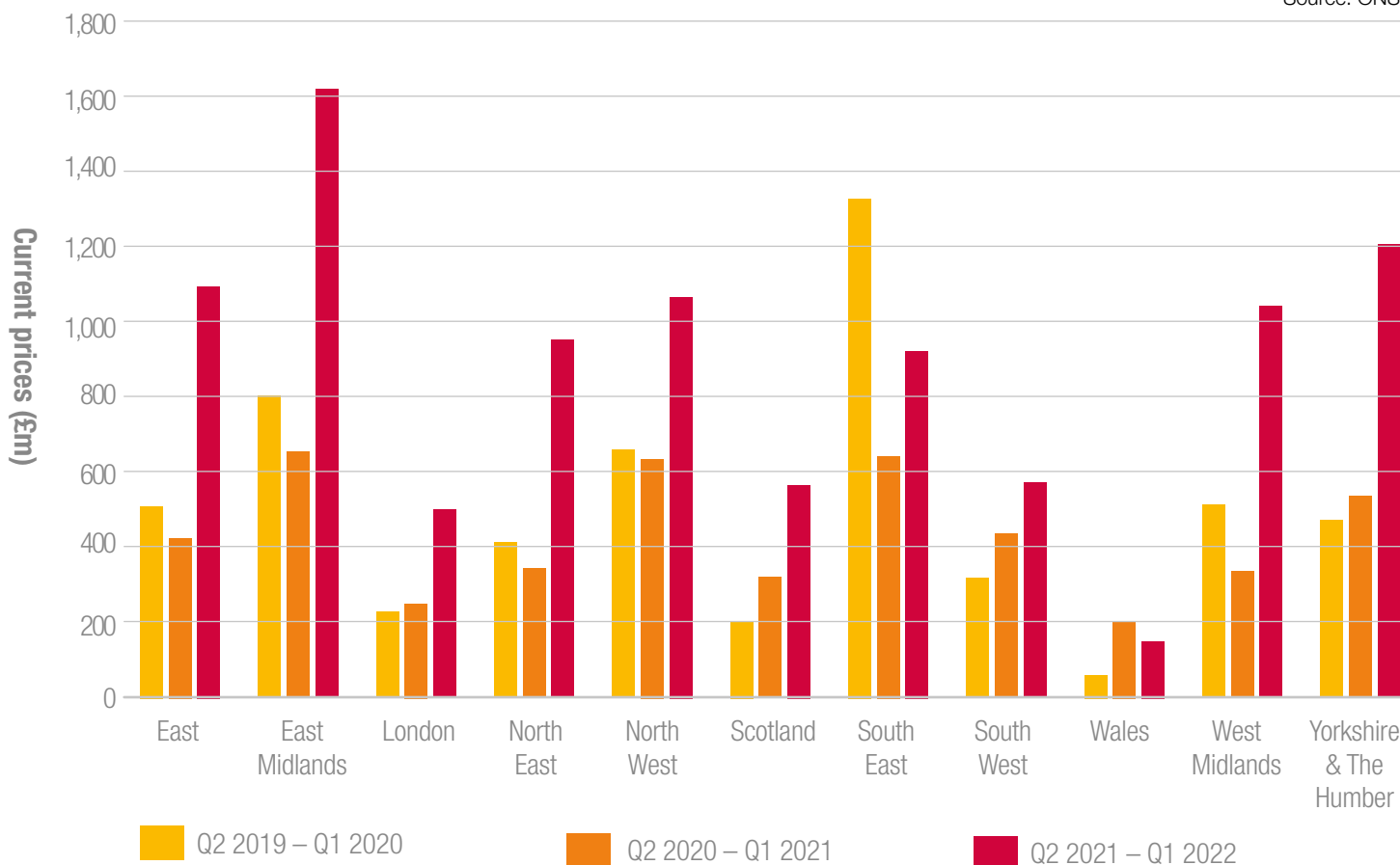


For London, Q1 2022 was very strong and while the nominal data makes comparisons with previous quarters difficult, it is one of its best since the global financial crisis. What makes the first quarter even more successful is whereas it may not have been quite as strong as when some of the HS2 contracts were signed, the growth was broader based. Housing, infrastructure and private commercial all had a well above average quarter as the capital's economy rebounded. The sizeable new orders in two of these categories are fairly noteworthy. In the wake of the pandemic, much of the news around housing focused on a flight away from London, towards leafier suburbs. However, even before the latest set of numbers, there was no evidence housebuilders were abandoning London, and Q1's figures further dispel the idea. Similarly, the move away from working in the office should have significantly dented demand for new space, yet a string of positive private commercial data, where London dominates, again doesn't back-up the story.

Unfortunately for the Government, data from the regions also doesn't really support the idea that levelling up is taking place yet. In nominal terms, excluding London, only four other regions have seen their new orders grow by more than 10% over the past five years. Given the change in the implied output price deflator over the same period is almost 15%, this means many areas will have had their new orders shrink considerably. While the pandemic creates issues looking for trends based on the last five years, it is difficult to see many places seeing a steady improvement. One reason for this is infrastructure new orders are over 20% smaller in the last four quarters than they were in the four quarters between Q2 2016 and Q1 2017. This is somewhat surprising given how well infrastructure output is doing, and some of this is due to the timing of contracts. Similarly, some transport projects, such as HS2, may cover several regions but the numbers will not be split up, and instead go to just one area.

PRIVATE INDUSTRIAL NEW ORDERS

Source: ONS



Nonetheless, it does appear that the common criticism that London is getting more than its fair share of infrastructure spending is still true. In addition to issues with infrastructure, part of the weakness outside London is that there has been relatively little nominal growth in new orders for housing or private commercial, the two largest sectors.

Private industrial is the sector where there has been most growth since the pandemic, and it is also the one where London is relatively the weakest. For most sectors, London is comfortably the largest region, but with private industrial, only Wales was smaller last year. This distributional split, alongside the fact new orders rose 92% in 2021, makes the sector more interesting than its small size would usually justify. Growth was particularly fast in the East, East and West Midlands, North East and Yorkshire and the Humber.

However, unfortunately, private industrial is one of the smallest sectors. While its share of new orders rose to 14% in 2021, up from 9% the year before and almost twice as much as in 2017, it is still less important than every sector bar the two public ones. It is even weaker based on output figures and as such its recent strength will only provide limited help with growing the industry. Additionally, it is questionable whether logistics centres and warehouses are what the Government would mean when talking about levelling up. It is unlikely these jobs will be high wage, high skilled or able to help with the UK's productivity problems. While the UK still has a considerable need for more warehouses, other than to the developers building the space who are currently seeing substantial returns, the wider benefits are possibly less clear cut.

For the moment, the cost pressures are equal across the UK, so we think it is still too early to be differentiating between the London and the wider national forecasts. One quarter of very strong data is not enough to fully justify such a move, especially as there was a larger drop-off in London than elsewhere in the preceding year. We would not usually expect material price inflation to noticeably differ across the country, and at the moment, when products are rising so rapidly due to global factors and higher energy costs, this is even less likely to be the case. However, were there to be more quarters where new orders in London grow significantly more than elsewhere, it may be necessary to take another look at this.

Mace

155 Moorgate
London EC2M 6XB
+44 (0)20 3522 3000
www.macegroup.com

Contacts

Matthew Fitzgerald
Mark Williams
James Donald

+44 (0)203 522 3468
+44 (0)20 3522 4597
+44 (0)20 3824 3185

matthew.fitzgerald@macegroup.com
mark.williams@macegroup.com
james.donald@macegroup.com