UK MARKET VIEW

Recession may be shallow, but steep fall in new orders is a concern

Q1 2024

Introduction

Over the past quarter, material prices have continued to drop and there are now signs that labour costs are starting to fall. However, while this is good news, developers need to be careful of those who are aggressively cutting bid prices. Weakening pipelines are likely to encourage some firms to squeeze prices by more than is achievable in order to secure work.

Supply chains are still fragile, and work won at ultra-low prices won't help repair them. Suppliers are also facing problems from high credit costs, meaning that paying on time is vital in order to keep some afloat. We expect interest rates to start falling soon, but it will take time before some of these credit problems become less serious.

Andy Beard
Global Head of Cost and
Commercial Management

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GDP fell...

0.3%

in the final quarter of 2023 and, as a result, the UK economy is now in a recession.

While construction output's growth of 2% last year outpaced services and manufacturing, there is no momentum in the sector, and in Q4 it shrank...

1.3%

New orders dropped in Q4 and were down...

20.9%

for the whole of 2023, suggesting construction output is likely to drop further.

Construction pay growth has slowed rapidly since early 2023 and, in the fourth quarter of the year, it fell...

0.5%

Interest rates remain at...

5.25%

but the expectation is that these will start to steadily come down later in the year.

Tender prices

	2023	2024	2025	2026	2027
National	3.5%	2.5%	3.0%	3.0%	3.5%
London	3.0%	2.0%	2.5%	3.0%	3.5%

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.

Setting the scene

2023 finished with the UK in a recession. It may be a very shallow one, but there have now been two successive quarters of negative growth, and this has left the economy just 0.1% larger than it was in 2022. Overall, last year wasn't too bad for construction, its annual growth of 2% was notably stronger than both services and production, which fell. However, the industry's strength came from the repair and maintenance sector, and all new work shrank 2.1%. This reduction was mainly due to falling output in the residential sector, and the more concerning aspect for the wider industry is the lack of new orders. Declining over 20% last year, it points to not enough new work coming through and a very difficult year ahead. Such a downturn will likely lead to many firms sharpening their pencils, while lower material prices should also help them become more price competitive . Between Q4 2022 and Q4 2023 – which is what assess for our tender prices – construction material prices fell 2.1%, although this follows several years of very large rises. Also having an impact is a drop in construction pay. Even so, despite this recent shift, earnings were still almost 4% higher than at the end of 2022. Overall, we believe tender prices rose by around 3%-3.5% in 2023, much lower than the levels seen in the preceding years, and inflationary pressures should continue to cool this year as output comes under further strain.

As we have mentioned in previous reports, 2024 is going to be another challenging year. Economic growth will be slow, only gradually picking up. The construction pipelines that finished last year looking sparse will likely keep output figures under pressure, and risk aversion from both clients and the supply chain could hinder the process to get contracts signed. Despite none of these headwinds being insurmountable, they don't lend themselves to a particularly prosperous outlook. Additionally, the insolvencies that besieged the industry last year not only persist as a problem for live projects, but leave a shadow of ongoing reduced competitiveness. In some cases, the drop in the number of specialist subcontractors as a result of insolvencies, and the stronger hand those still operating subsequently hold, is pushing prices up and leaving some contractors with little choice but to accept. Naturally, when developers are trying to tighten budgets, this can create an impasse. It is not uncommon to see examples of falling competition and risk aversion outweighing concerns about a lack of projects and economic weakness. How these conflicting forces interact will have a huge impact on project specific tenders and, while average tender price inflation will ease, difficult conversations will not.

Many of these difficult discussions will centre on the short and long-term risks and perceived justifications for price increases. The ongoing attacks on commercial ships in the Red Sea are currently recognised as a potential risk for construction, rather than already having had a notable impact. The biggest threat to the economy is a surge in the price of oil, such is the global importance of the resource. Even so, while the Houthi attacks at the start of the year pushed Brent crude past US$80 per barrel, they haven't risen further since; oil being at around the same price as it averaged in 2023 shouldn't be triggering inflation. Meanwhile, the cost of shipping is also going up, but this should be manageable. In 2021, freight costs jumped much higher than current levels and, while the Red Sea and Suez Canal present an incredibly important shipping route, this is not a broader global issue. Events in the Middle East may currently be the biggest geopolitical risk for construction, but the US Presidential Election and ongoing Chinese property crisis are two others to watch in 2024.

One area that should become less problematic this year is interest rates. The expectation is that they will fall, but it is important to keep expectations in check, noting that forecasts suggest it will take almost two years before interest rates return to the level they were at the start of last year.

And, of course, the impending general election – expected in the Autumn – is framing much of the debate. We finish this report looking towards the election, setting out some priorities for a future government, and how the industry could provide support. With no mention of the word 'construction' in the 98 page budget document, there is plenty of potential for progress.

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The past: UK falls into a recession

GDP

The publication of GDP data for Q4 2023 showed that the UK had fallen into a recession. With a recession defined as two successive quarters of negative growth, the economy followed its fall of 0.1% in Q3 with a 0.3% decrease in Q4. Overall, for the year, GDP rose just 0.1% but, in per capita terms, the economy shrank 0.7%. Showing how a rising population is the main factor behind the growth, it also means, on average, people are becoming poorer. Excluding Covid, this was the economy's worst performance since 2009 and there were few positives to take away from any sector. One of the main reasons for this sluggishness was weakness in household consumption. With real wages virtually unchanged on average last year, and with households facing much higher mortgage costs, it was unsurprising that services, the economy's largest component, barely grew.

Construction output

While construction was 2% larger in 2023 than it was in 2022, there are several other indicators that show the industry is struggling and conditions have recently worsened. Firstly, all new work declined 2.1% for the full year. A considerable increase in the repair and maintenance sector meant the overall industry expanded but, for the purposes of our tender price analysis, these smaller projects are much less relevant. Although, in annual terms, infrastructure and private commercial, as well as public housing and non-housing rose, poor figures in the housing sector dragged overall all new work numbers down. However, in the final quarter, it was only the two public sectors which saw growth. All the others shrank, leaving all new work down 5% on the quarter. By now, and following five successive quarters of decline, the weakness in the private housing sector is well established. That other sectors are also falling shouldn't necessarily come as a surprise given previous new orders numbers, and as we show next, worse could be to come.

OUTPUT ROSE IN 2023 BUT THERE WAS A POOR FINAL QUARTER

Source: ONS

New orders

New orders dropped 13.1% in the final quarter of last year, meaning the industry moved into 2024 in fairly dire fashion. Dragging new orders down in the final quarter were significant drops in private housing, private industrial and private commercial. However, more worryingly than the latest reduction is how far all sectors bar public new housing have fallen over the year. Compared to Q4 2022, private industrial has slumped the furthest, more than halving in size. Having seen large gains following the pandemic, and possibly some short-term oversupply in warehouses, new orders shrank in every quarter last year. A combination of higher interest rates and a lower share of online retail sales, as well as general weakness in retail sales, caused this extensive decrease.

Between Q4 2022 and Q4 2023, private housing, infrastructure, public non-housing and private commercial all saw falls of between 25% and 30%. While higher interest rates are the obvious explanation for housing's difficulties, there is not the same relationship to public sector projects. The vast majority of the drop in infrastructure came from public sector funded projects, notably roads. Meanwhile public spending on new schools and colleges had a terrible final quarter to the year, whereas the health sector, which had had a very strong Q1 2023, struggled in each of the following three quarters. Overall, in 2023, new orders were 20.9% lower than they were in 2022. Given output of all new work only fell 2.1% in 2023, the weakness in new orders suggests there may be a long way further for it to fall.

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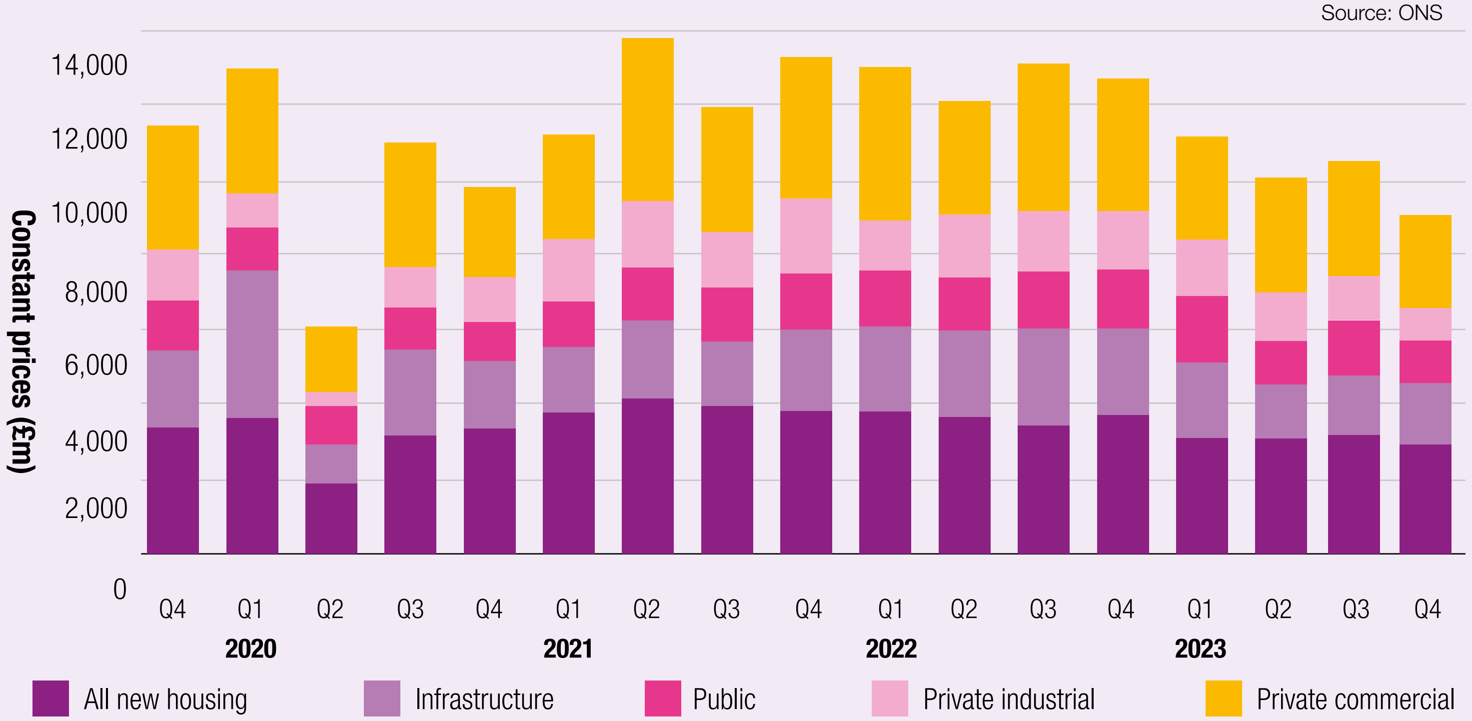
NEW ORDERS DROP AGAIN



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Labour costs

For construction, regular pay growth peaked in March last year at 6.5%. While at the time this meant it was only the finance and business services sectors that were rising at a faster rate, by the end of the year construction pay growth had slowed to 3.8%. By contrast, during this time all the other sectors, including the public sector, had peaked at a higher level than 6.5%, and also had finished the year growing faster than construction. Construction's slowdown was particularly apparent in the final quarter, when wages fell 0.5% relative to Q3. Despite this recent fall, that wage growth was so high earlier in 2023, combined with the difficulties in resourcing, meant tender prices were driven up. Vacancies remain much higher than they were pre-pandemic and the percentage change in vacancies compared to 2020 is much larger in construction than in most other sectors. If firms continue to find hiring problematic, then wage pressures could return. However, given falling output it is possible that vacancies will drop and, as a result, wage growth should have less of an impact on tender prices in 2024.

Material prices

Despite average material prices being 1% higher in 2023 than 2022, the trend for much of last year was one of weakness. The jump in prices that followed the start of the Ukraine war is still being felt but, between Q4 2022 and Q4 2023, the 'all work construction material price index', was down 2.1%. This softening of prices includes eight successive month-on-month drops, going back to May. However, while the overall index has deteriorated, many products are still higher than they were a year ago. This includes concrete and a variety of plastic products. At the other end of the spectrum, steel prices fell consistently throughout 2023. Down almost 20% since December 2022, fabricated structural steel is now around 40% below its peak. Yet even after this sizeable drop, the product is still 40% higher than it was at the start of 2020, a similar rise as the wider material price index over this time period. The lag in passing price rises onto tender costs may be over, but the challenge of proving schemes are viable at these higher costs is not.

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The present: When will The Bank Of England cut interest rates?

Politically, the expected general election will dominate the news cycle this year. Meanwhile, economically, the most important questions relate to interest rates. Firstly, when will the Bank of England start to cut rates, and following on from this, how far and how fast will they go? The construction industry, and in particular the housing market, will be hoping the Monetary Policy Committee (MPC) slashes rates rapidly, but is likely to be disappointed. While rates should start coming down in the middle of the year, the descent will be slower than when rates were going up, and they won't be returning to the levels seen in the 2010s.

At the MPC's last meeting at the start of February, there was disagreement amongst members about the correct direction of travel. Six members voted for no change, two wanted rates to rise and, for the first time in this cycle, a member voted for a rate cut. As a result, interest rates were left unchanged at 5.25% and, looking at the minutes from that meeting, a move in March seems highly unlikely. Despite being in a recession, the MPC is more concerned about inflation and the tight labour market. Although CPI inflation is now at 4%, core inflation – which excludes food, energy, alcohol and tobacco – is 5.1%. Similarly, services inflation is 6.5% and much of this is driven by ongoing wage increases. Rising wages are also likely to continue with the National Living Wage due to increase by almost 10% in April. The Bank of England's Regional Agents also found that the average pay settlement in 2024 was likely to be 5.4%. Lower than last year, this is still high enough to give the MPC pause for thought, prompting members to wait and see just how wage increases feed through in the next few months. As a result of these factors, current market expectations are that the first move will be in either May, or more likely June.

Following the first cut, economists are expecting a further two in 2024, followed by another four in 2025. This would leave interest rates at 3.5% at the end of next year, but much will depend on how the economy performs. Here, the Bank of England's latest Monetary Policy Report offers some guidance about what it believes will happen. Importantly, it thinks CPI inflation will ease to 2% in Q2 2024, before rising back up and reaching 2.7% at the end of the year. Showing the Bank's concern about inflation being persistent, it is also noticeably higher than the 2.2% that the HM Treasury Collection of Forecasts is reporting. Whereas inflation dwindling on the downside would support the MPC in cutting rates, neither the Bank's forecasts, nor others, point to a year of healthy growth. GDP is set to only pick-up slowly, rising by 0.4% for the full year. After such a weak 2023, the lack of obvious momentum highlights the wider challenges facing the economy.

For housing, such gradual interest rate moves are also likely to lead to limited momentum, with no immediate recovery. Interestingly, some mortgage products are currently offering rates lower than the Bank Rate. This is uncommon and shows that lenders are moving in advance of expected action from the Bank. Having come down in the past few months, these are also helping stabilise house prices, and should, in turn, give housebuilders confidence. Nonetheless, with housing output down by more than 10% last year, there is plenty of scope for a pick-up, even if it is likely to be slow. Furthermore, if interest rates do return to 3.5% in two years, this will only take them to the level they were at the end of 2022 when housing output had already started to fall. One of the most telling results from the Competition and Markets Authority's Housebuilding Study was around how housebuilders' build out rates are dependent on local absorption rates. Given interest rates of 3.5% are likely to lead to lower absorption rates than when the Bank Rate was 0.1%, a full recovery could be a long-time coming.

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The future: How could a new government help construction?

The approaching election means now is the time to start thinking about what political parties of all colours might want to consider in order to support the construction industry. Given the importance of housing and infrastructure, merely focusing on its 6% share of GDP massively underplays the sector's importance to the economy. With the sectors' tangible impact on daily life, government support provides more widespread confidence and benefits. The opportunities for improvement are many and nearly all hinge on meaningful two-way conversation between industry and government. From longstanding issues with the planning system, to calls for more emphasis on the Construction Playbook, to the need for clarity on net zero, the picture is complex. We've covered just some of the most pertinent matters below.

One of the most pressing issues industry and government need to tackle together is how to get more people working in construction. As the National Infrastructure and Construction Pipeline shows, to meet infrastructure demand requires significant numbers of workers. Skills shortages are regularly citied as a challenge for successful project delivery across all types of construction work, while the jump in vacancies after the pandemic suggests conditions have worsened since 2020. Key to attracting people into the industry is showing the depth of roles available. In particular, digitalisation opens up roles to a greater variety of individuals. The benefits of making construction more appealing to young people won't be immediate, but it is critical. It will also become increasingly important, not only because of the UK's ageing population, but because of growing international competition. Countries such as Saudi Arabia are investing significant sums in infrastructure and presenting a compelling offer to talent. Worryingly, data from last year shows a fall in the number of apprentices, so there is a risk the industry is moving in the wrong direction. Given that fewer than 10% of apprentices are female, one aim must be to make the industry more appealing to young female workers.

Being a new qualification, it is unsurprising that T Levels are not perfect. An Ofsted report published last year complimented providers on working with construction firms to secure placements, but also mentioned that placements could involve significant travel. Vocational qualifications are important but the the effectiveness of them needs to be improved. Targets should include increasing both the number who study and complete the course.

Construction could also benefit from a new government spending more of its various budgets on capital expenditure. Since 2010 there has been a clear divergence between total government expenditure, and the amount going to construction new orders. We regularly discuss whole life costing with clients, advising them that cutting capital costs can lead to higher operational expenditure later. Recently, health and education seem to be facing the opposite problem; with keeping schools and hospitals running rather more of a priority than developing them for the future. The issues with RAAC highlight what happens when new development or the necessary renovations and improvements to existing stock are not carried out when needed. Not only does avoiding spending in the short run often lead to higher long-term costs, but there may be other serious implications, such as the risk of injury and school closures.

Another area requiring serious consideration is how modern methods of construction can work in the residential sector. Increasing its usage will help with

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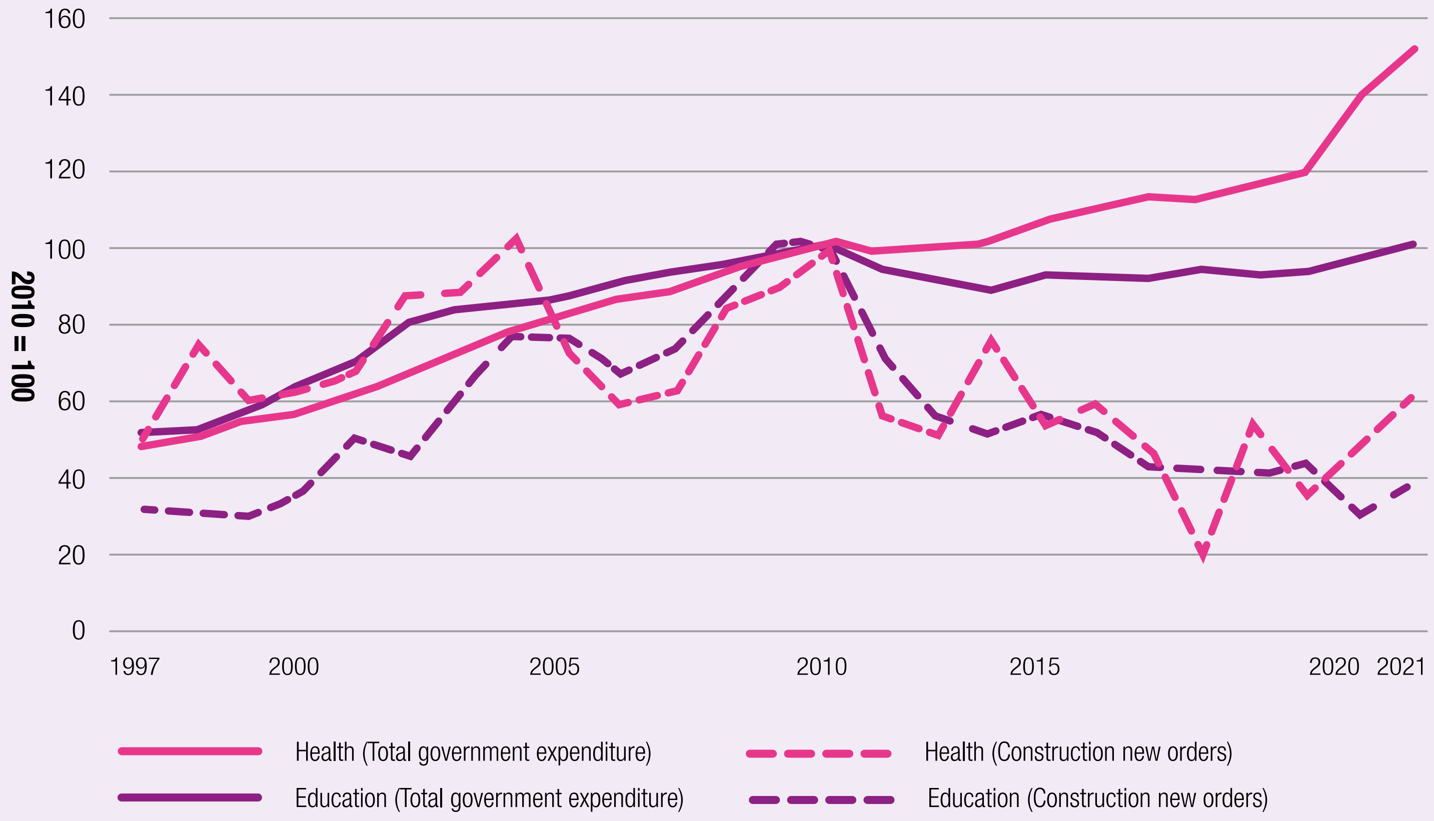
CONSTRUCTION SPENDING ON HEALTH AND EDUCATION HAS FALLEN CONSIDERABLY

Source: ONS, Mace calculations



skills shortages and is likely to prove essential to achieve net zero and deliver the number of homes needed. However, the collapse of Urban Splash and Legal & General's modular arm, along with TopHat, another modular housebuilder, announcing it would be making a number of job cuts show that MMC is not working in the way investors would like. The failings are recognised in a recent letter to the government from the Lord's Built Environment Committee. Describing the government's approach to MMC in housing as "in disarray" and without a coherent strategy, it is clear there is plenty of room for improvement. As the letter mentions, the first step is defining a strategy for MMC. Developing such a policy may not be straightforward, but the suggestion that one is necessary is. This is also something the wider construction industry should be able to help with, sharing lessons of success and failure. While MMC, and in particular modularisation, is commonly struggling to make the right noises in the housing sector, there are examples in other sectors – at airports, for example – of the innovation being used to good effect. Investing in factories is costly, and it may be that these risks are too large for individual housing developers to take on. Therefore, how to grow the wider supply chain becomes a key question.

One final hope is that the seemingly revolving door for government ministers stops rotating. In particular for the construction sector, the frequent change in the Minister for Housing has been a problem. Since 1997, the longest serving minister was in place for less than three years, and on average they have lasted for little more than a year. Such upheaval makes it impossible for whoever has the role to get to grips with the challenges. The housing market, and the struggles many face to get on the ladder is one of the UK's most topical and prominent failings. Fixing this is a monumental task, but having stability in Westminster will help to bring clarity. On a related note, it should be highlighted that the new Ministerial 'Star Chamber' that the government was planning on forming to help infrastructure delivery is yet to emerge and, more than three months after the announcement, there is still not a minister in place. Yet again, action hasn't aligned with words and it is unsurprising that confidence in the current government's commitment to building the infrastructure the nation needs is waning.

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