mace

UK MARKET VIEW

AS MATERIAL PRICES DROP, PAY PRESSURES PICK-UP

Q1 2023

That the economy didn't fall into a recession at the end of last year is somewhat of a relief, but the challenges for the coming year remain stark. There were numerous insolvencies in 2022, and project teams will need to be alert to the risks these hold. The decision to review timescales for multiple large projects highlights the fragile nature of the industry.

Sectoral differences will play a key role this year. Those focused on housing, or the subcontractors affected by major project delays, will have recruitment freezes and be desperate for work. Others, including those whose business centres around roads or warehouses, will be busier. This will lead to considerable variability in pricing, and result in tender movements being truly project specific.

While rising interest rates will have done little to help the precarious financial position of the supply chain, material costs starting to ease is welcome news. Lower energy prices should help some product prices slip further, although it might take some time before this fully feeds through, and prices will remain much higher than they were two years ago

Andy Beard
Global Head of Cost and Commercial Management

	2022	2023	2024	2025	2026
National	8.0%	2.5%	2.0%	2.0%	3.0%
London	8.0%	2.5%	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.

There was no change in GDP in Q4, meaning the economy narrowly avoided falling into a recession.

Helping prevent a recession was construction, albeit output growth of...

0.3%

in the final quarter was its weakest of the year.

Material prices falling in four of 2022's last five months helped inflation ease to...

13.1%

By contrast, labour costs continue to steadily rise, and the annual rate of regular construction pay growth finished the year at...

6.1%

While new orders declined...

1.8%

in Q4, last year was the best since 2017.

SETTING THE SCENE

2022 was another difficult one for construction, and once again material price rises were at the forefront of these challenges. In Q2, as a result of the Ukraine crisis, construction material prices rose 10%, comfortably outpacing all the unwelcome quarters in 2021, when material price inflation was also sky high. Nonetheless, by the end of the year, conditions had improved and material prices had started to drop. This is significant as, when we discuss tender price inflation, we think about how much prices have changed between the final quarter of one year and the previous year's final quarter. In last year's case, we are comparing prices in Q4 2022 with Q4 2021. Based on this timeframe, material prices rose 13.1% over the 12 months. By comparison, between Q4 2021 and Q4 2020, material prices had increased 23.3%. Timing, therefore, becomes very important, and when contractors and sub-contractors pass on their costs can make a big difference.

Whereas material price inflation has started to come down, the annual pace of growth of regular construction pay increased throughout last year. Notwithstanding the aftershock of Covid, construction pay accelerated from 2.2% to 6.1%. While not quite as high as in the services sector, and noticeably lower than consumer price inflation, it is still rising rapidly. CPI should still fall this year, but that it rose slightly in February to 10.4%, may be a sign that prices prove stickier than hoped for. This, therefore, puts sub-contractors in the unfortunate position of having to juggle several adversities simultaneously. In conjunction with Mace Construct, we have conducted a survey of the Mace supply chain to gain a better understanding of this. The share of respondents where there were double-digit growth rates for the Q4 – Q4 change was noticeably larger than last year, with concrete structures standing out as particularly significant. Another key package which also saw a substantial rise was MEP. In particular, there was a spike in Q1, followed by further, albeit not quite as extensive, rises in the remainder of the year. Possibly surprisingly, given the shifts earlier in the year, certain steelwork components only increased around 6%. However, this makes more sense once we consider the reduction in prices in the second half of the year and the BEIS index on fabricated structural steel was only 2.4% higher in December 2022 than 12 months earlier. Overall, we think 8% is reflective of last year's rise. Added to our forecast of 7.5% in 2021, it means we believe tender prices are over 16% greater than they were two years ago. Following such sustained pressures, it will be a relief to many that we expect tender prices to rise just 2.5% this year.

Having barely avoided a recession at the end of 2022, expectations are for the economy to shrink this year. Finishing the year with one quarter of negative growth, followed by no change in GDP in Q4, shows the economy is struggling. In particular, real pay has never been falling so fast, interest rates have risen substantially, the government has had three different prime ministers and the implications of Brexit persist. While on a more positive front unemployment remains incredibly low and further falls in the price of gas may help bring inflation down faster than expected, there is a strong consensus that GDP will shrink. We discuss these macroeconomic issues in detail later in the report, but the strength of this consensus makes it difficult to be overly optimistic about construction's prospects.

For construction, the best indicator of what will happen in the near term are new orders. Here, there was a small dip in Q4; not enough to suggest the industry is on a cusp of a significant downturn, but likely a warning of things to come. Even with the 1.8% drop in the final quarter, new orders were 1.2% higher last year than in 2021, making it the best year since 2017. Yet there are questions about how quickly these schemes will proceed and, given the economic difficulties, a fall in construction output seems likely this year. Curiously, given the turmoil in the mortgage market and some of the largest housebuilders highlighting the challenging operating environment, the last three months of the year saw a rebound in the private housing sector. While total new housing orders were almost 10% lower than in 2021, Q4 was its strongest quarter of the year. A weak housing sector, likely to see a noticeable decline in output, is one of the main reasons why we expect tender price growth this year to be modest.

THE PAST: MATERIAL PRICES DROPPING

Material prices

By the end of 2022, there was clear evidence of construction material prices dropping. In the final quarter of the year, prices had sunk 1.2% compared to Q3, with monthly declines in four of the past five months. Relative to its peak in July, the 'all work construction material price index' was 3.6% lower. While this all means that some of the pressures facing contractors are starting to ease, it would be unwise to overstate the cooling effects, and prices are still a considerable problem.

On average, material prices were 19.4% higher last year than in 2021 and, between December 2021 and December 2022, they had risen 11.2%. Additionally, prices are still over 40% higher than in the middle of 2020 and coming out of the initial stages of the pandemic.

Helping matters are retractions in two of the materials which had seen the largest moves. In particular, from its peaks in the middle of 2021, there have been sizeable falls in timber. Imported sawn wood is nearly a quarter lower than in December 2021, with imported plywood down by over 10%. Furthermore, both products had fallen around 15% in the final three months of the year. Steel, while having increased in the past 12 months has also started to come down, including fabricated structural steel finishing the year 12.1% lower than in September. Yet, when discussing these moves, we must recognise how high prices had shot and just how high they still are. Compared to December 2020, rebar is up 80%, with imported plywood rising around 30%. It will be a while longer before prices return to normality.

COOLING MATERIAL PRICE INFLATION

Source:BEIS

Construction output

As a whole, last year was always one where solid growth was likely. Comparing it to 2021, when the early part of that year was still suffering from problems caused by Covid, almost guaranteed growth and, overall, construction output rose 5.6% for the year. What is more important is that growth, while slowing, occurred in each quarter and, in total, the industry is now 3.2% larger than just before the pandemic. Private industrial was by far the fastest growing sector last year, with output increasing over 40% while there was also robust growth in private new housing and private housing repair and maintenance. By contrast, infrastructure, public non-housing and private commercial all had lower output in 2022 than the year before.

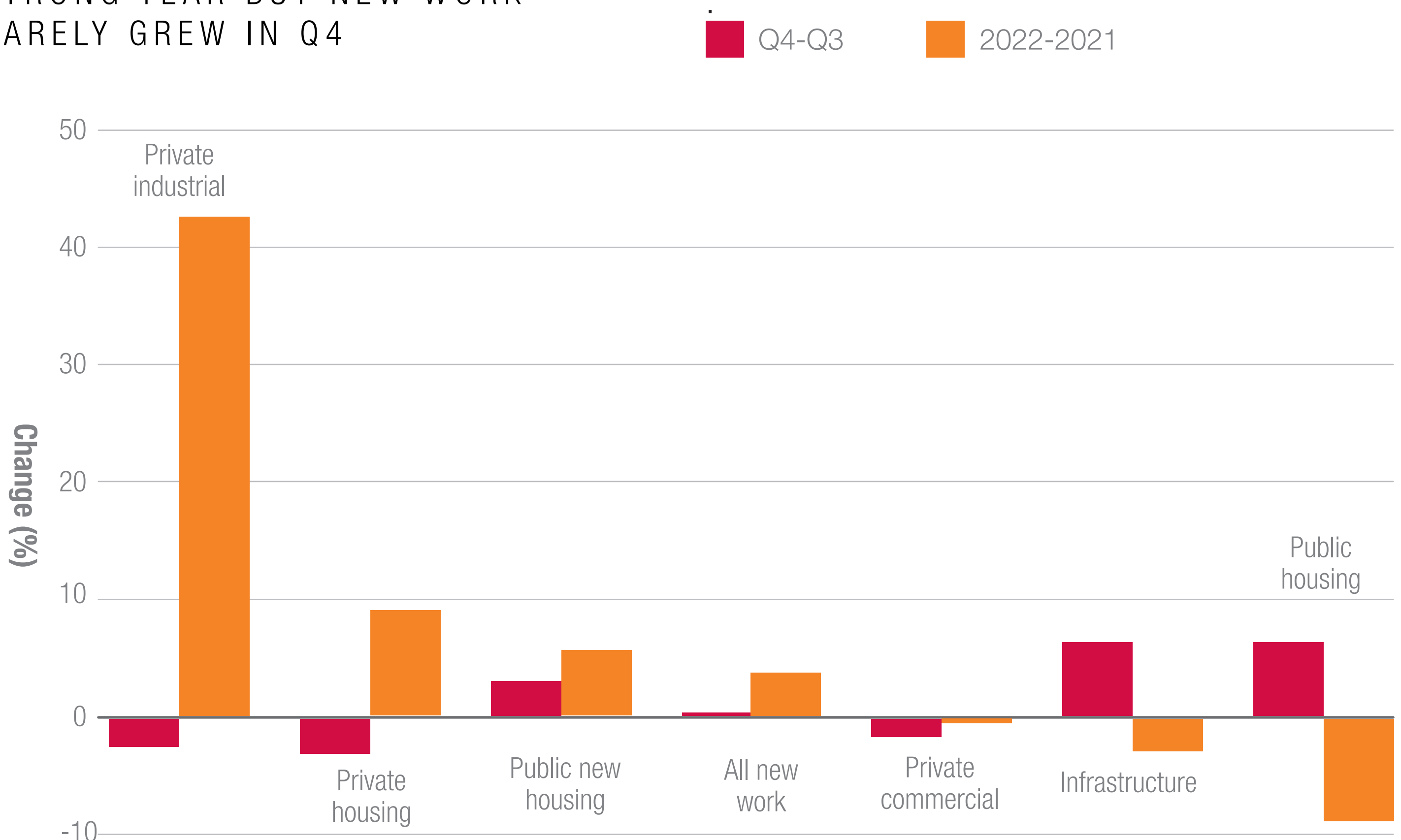
Yet, by Q4, some of the tables had started to turn. In particular, private housing output, both for new properties and repair and maintenance shrank. This is the sector most dependent on household spending and, with real incomes falling, is facing considerable headwinds this year. New private housing declining over 3% in Q4 is a concern, given it accounts for nearly 40% of all new work.

Whereas infrastructure had slumped following a huge rebound in the second half of 2020 and first half of 2021, the public sector is still well over 10% below its pre-pandemic level. The pressure to local authority budgets makes it difficult to foresee this shortfall reversing soon.

One sector faring even worse than public non-housing is private commercial. Still almost 30% down from before the pandemic, it did see growth of 6% in the third quarter before slipping back 1.5% in Q4. Whereas new orders for private commercial in the past two years appear relatively healthy, this is not feeding through into higher output. This drop certainly reflects problems in the retail sector, but offices form the largest part of private commercial. One explanation for this is that projects are taking longer to get from contract to site. It's possible, as we have often advocated, that contractors are being engaged earlier, leading to a longer pre-construction services agreement period. If this is the case, we would expect output to pick-up soon. Lower output also potentially shows that the shift to working from home is outweighing any growth arising from changing office space to allow for hybrid working or sustainability requirements.

STRONG YEAR BUT NEW WORK BARELY GREW IN Q4

Source:ONS



Labour market

By the end of 2022, regular construction pay was rising at over 6% a year. Excluding the rebound from furlough, this makes it the fastest rate of growth since the end of 2007. Yet even with such rapid growth, it is still a long way short of the inflation rate, and real pay is falling sharply. Regular pay growth for the whole economy was 6.7% and, while large increases in the services sector mean it is rising faster than the construction sector, by the end of the year, real pay was 2.5% lower than 12 months previously.

High nominal pay but falling real earnings, alongside ongoing vacancy issues, causes problems for both employees and employers. For employees, it means losses in spending power and a need to push for more pay. Employers, encountering significant skills shortages and a lack of labour, may respond to these pressures by meeting these requests and trying to pass these higher costs onto clients. At a time when material prices have also risen dramatically, this will have led to many difficult conversations about costs. From an employer worried about keeping costs under control, the end of the year may have offered some optimism. Construction vacancies had fallen to their lowest level in a year, while bonus payments have been easing since the spring. Not only does this help with total pay, where growth is now 5.5% as opposed to 8.2% in May, it also suggests some of the worst issues around labour shortages are easing.

As part of the Budget, the government decided to accept the interim recommendations from the Migration Advisory Committee. While making it easier to get visas for a number of occupations, including bricklayers, roofers, carpenters and plasterers, this won't have an immediate effect, but should start to help alleviate some pressures by the end of the year.

THE PRESENT: 2023 WILL BE ANOTHER DIFFICULT YEAR

GDP set to fall in 2023

The vast majority of respondents to February's release of 'HM Treasury's Forecasts for the UK economy: a comparison of independent forecasts', expect GDP to decline in 2023. Of the 21 banks and consultancies who provided a forecast, only one believes there will be positive growth, with another anticipating GDP to be unchanged. This leaves 19 businesses predicting a decline of some kind and, while the average is for a 0.7% drop, the forecasts for several have GDP falling by over 1%. These headwinds undoubtedly spell problems for construction.

Notably, construction is a cyclical industry, so when the economy is faring well, it tends to be strong. However, in a downturn, with confidence low, developers of all kinds often shy away from new projects. Current headwinds only make matters worse. Firstly, rising interest rates mean that anything that is built on credit or borrowing, is facing higher repayment schedules. Given debt is a necessity for large swathes of the wider construction industry, this is a significant problem. The recent jump in construction costs only makes viability assessments harder. There have also been anecdotal reports of higher construction costs hitting new local authority projects as, with funding provided based on older cost estimates, they can no longer continue with the schemes.

There are reasons as to why the economy may not shrink this year, however. These include healthy levels of optimism reported in January's S&P Global/CIPS PMI surveys. If firms are confident that sales will rise over the next year, then maybe economists should be too. Unemployment is also still incredibly low. While it has started to rise, it remains below where it was at the end of 2021 and, as long as people don't lose their jobs, they are unlikely to cutback significantly on their outgoings.

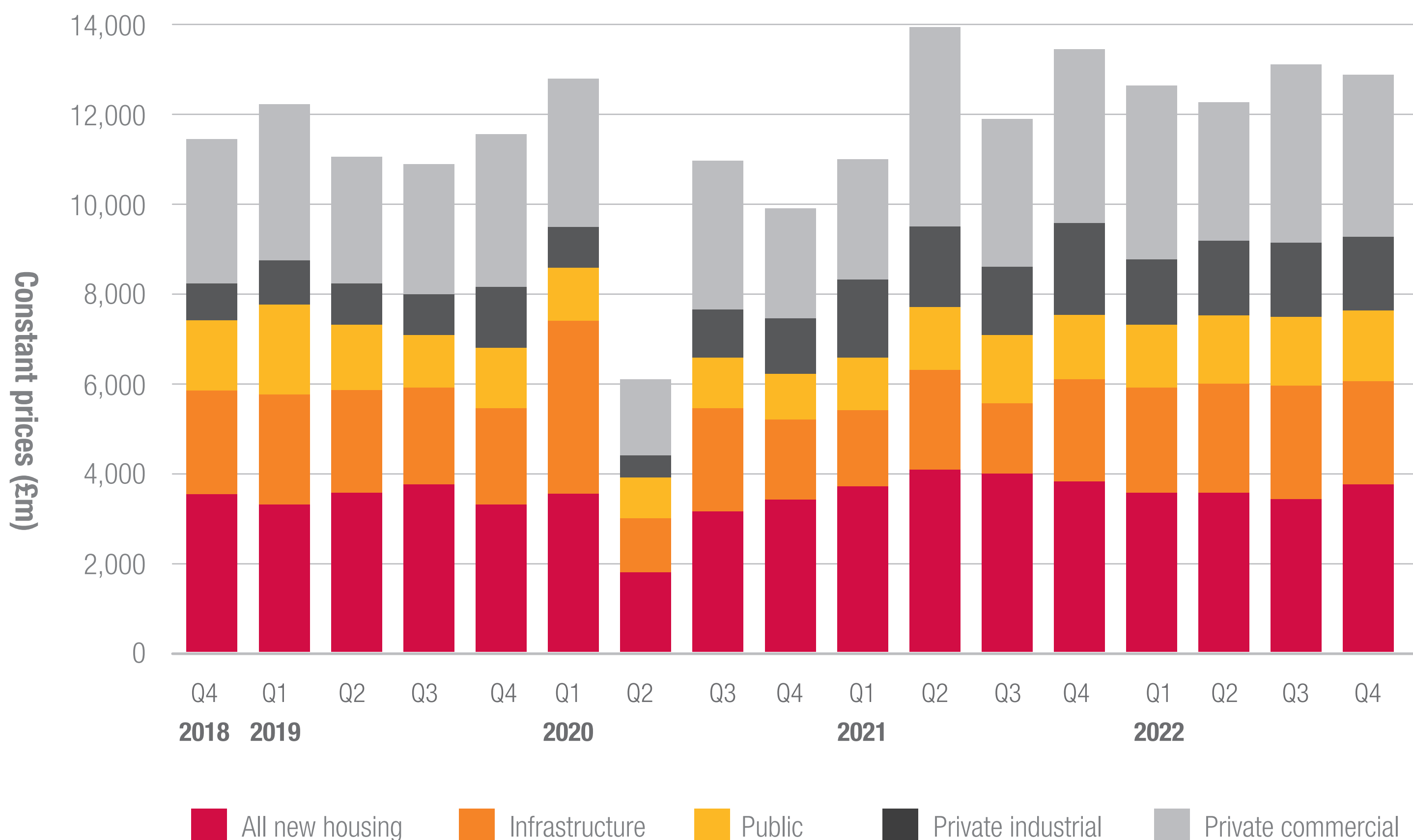
A final reason as to why the year may not be as bad as feared is that gas prices have slumped. Now at an 18-month low, it could lead to inflation falling faster than predicted which, in turn, would also help the Bank of England to start cutting rates earlier than anticipated. This scenario would likely put construction on a firmer footing moving into 2024.

The problems with Silicon Valley Bank and Credit Suisse will also have an effect on borrowing. Firstly, market expectations are now slightly weaker than they were and the chances of the base rate rising to 4.5% appears much more touch-and-go. More problematically for construction is the impact it will have on banks' willingness to lend. Credit conditions are likely to tighten, and for construction firms who banks already consider relatively high risk given the challenges facing the industry, borrowing will become harder. While it is still very early days to this banking crisis, such a tightening may more than offset any benefits from a weaker base rate. Similarly, it is another risk adding to the uncertainty in the economy and potentially increasing the fragility of the construction industry.

New orders

As mentioned in the introduction, new orders had a robust end to the year. The best performing sector in 2022 was infrastructure, with new orders rising 23.9% and every quarter last year seeing healthy figures, although its weakest outturn came in the final quarter. There was significant growth from electricity, as well as roads, although it was a weaker year for railways. The decision to delay parts of HS2 is likely to have a small impact on overall output, but potentially a much larger one on confidence about government investment and long-term plans. Last year was also a good one for the non-housing public sector, which increased 8.3%. However, that the largest growing component was the 'miscellaneous' category doesn't bode well for future repeat growth. Also worrying was the decline in its largest component, schools and colleges. Despite private industrial having the biggest drop in new orders in 2022, this was on the back of an incredibly strong 2021. Demand for new warehouses shows no signs of stopping and, whereas growth may have stalled, they will still account for much more of the wider construction industry's output than a few years ago.

SOLID YEAR FOR NEW ORDERS



China reopening

Material prices have been the catalyst for tender prices increasing so rapidly over the past two years. First, there were problems with supply chains following the global economy reopening after the pandemic, and then as a result of soaring energy prices from the Ukraine war. Their trajectory in 2023 is likely to be partly determined by China, a country which took a very different approach to Covid to the West. Having implemented a strict zero-Covid policy, in December, after mounting unrest, the government reversed course. This abrupt reopening led to commodities rallying in January on the belief of surging demand. Towards the end of February, copper and iron ore had rebounded to their highest levels since last summer. However, both metals are still noticeably down on their highs in 2021 and early 2022, and where they and other key construction products go next is uncertain.

For years, the infrastructure and property sectors have driven growth in China, and its need to rebalance towards a greater reliance on consumption is well known. Whereas in the UK over 60% of GDP comes from household consumption, in China it is less than 40%. Efforts by government to encourage this shift pre-pandemic had limited effect, but after several years of being unable to spend, there is now a glut of savings. Growing by US$2.6bn in 2022, the hope is that households will use these savings on consumer services such as personal care, entertainment and tourism. In such a scenario, there may be a less marked rebound in demand for commodities and the reopening of China would not trigger more widespread global inflation.

There are good reasons why Chinese consumers are often reluctant to spend, including a much poorer social safety net than in western countries. Therefore, it is quite possible that, instead of

growth led by consumption, the government decides that investment has to once again becomes the prime driver for growth. China consumes around half of many of the world's metals, with construction using a sizeable proportion. This share means that if demand surges, it has the potential to comfortably offset the weakness from the wider global economy. Caused in large part by government regulations, last year was a difficult one for the property sector. Yet, in an attempt to revive the industry, it appears these regulations have been abandoned, with banks once again freely lending. While it's good news if China doesn't have a real estate crisis, higher demand for commodities will help support prices through the year. As well as metals, there is energy, and this may hold the bigger risk to the UK. Weak demand from China allowed LNG to be diverted to Europe. Despite risks of shortages over the winter now looking over, a ramping up of Chinese demand may create new problems. As we are still seeing, higher gas prices have significant knock-on effects on UK inflation.

Timing of these movements is also relevant. For the moment, immunity across the population is steadily improving, but is not yet at a level where it is clear how the economy will perform. This is only likely to become apparent as we move into the second quarter, so it will take time before we know whether consumers are going to run down their savings and support the economy. If instead the government does step in and provide a stimulus, then it is much more likely to happen in the second half of the year. As such, it will be necessary to follow China's recovery closely as the year progresses.

While this means there are upside risks to inflation later in the year, China's reopening also has the potential, if not to be outright deflationary, to help dampen some material prices. With a full reopening of factories, an end to the supply chain problems that have beset the global economy could be on the cards. Nonetheless, we wouldn't want to overstate the impact of this and some of the easing of supply chain pressures has already occurred. The Baltic Dry Index, one measure of freight prices, is currently trading lower than it did during 2019 and much of the worse of the supply chain issues are now well over. As with any inflationary effects, we will be monitoring the impact on the supply chain closely.

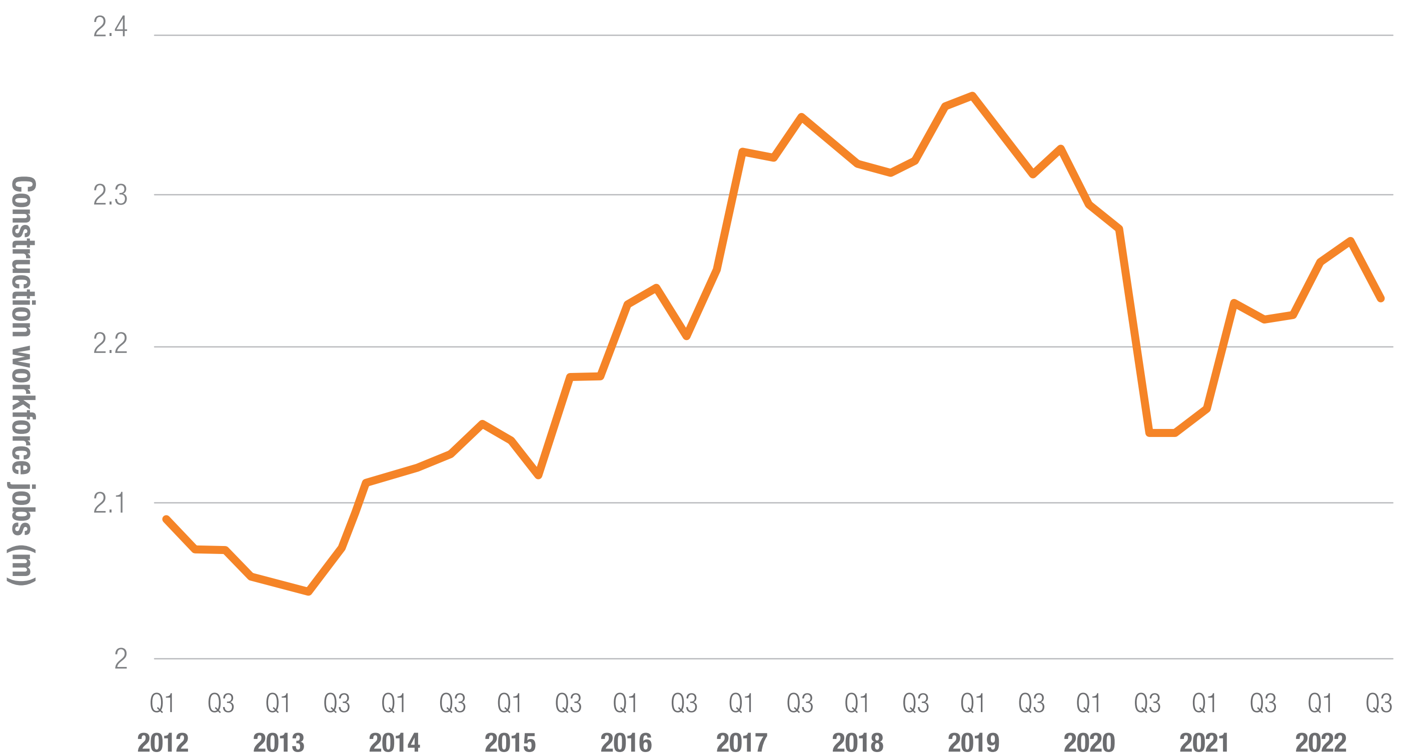
THE FUTURE: REBOUNDING FROM A RECESSION HOLDS RISKS

Our heading for this section last year was, “Growth to ease as a result of higher prices and rising interest rates”. While written just at the start of the Ukraine crisis, and therefore not envisioning inflation would top 10%, it still seems a fairly accurate assessment of where we are at the start of 2023. Looking now to 2024 and beyond, much will depend on how 2023 develops. However, if we assume that this year plays out in roughly the way the majority of forecasters expect, with GDP and construction output falling, then the following one will be a year where growth hopefully returns.

One problem with recessions is that unemployment rises. If there is a serious downturn in 2023, this could be a particular problem for construction in 2024. The number of people working in the industry has still not recovered from Covid and there were approximately 100,000 fewer construction jobs in September 2022 than December 2019. This shrinking workforce helps explain why vacancies are so high and is one of the reasons pay is growing so rapidly. If there is a noticeable recession this year that causes firms to let staff go, then they may find re-hiring them in any recovery problematic. For tender prices, this instability is also likely to be unhelpful with price volatility and uncertainty complicating budgets. If wage pressures do start to ease this year on the back of lower output, then there could just as easily be a resurgence next year if it rebounds. The skills shortages that exist are a long-term issue, and firms who overreact to this year’s problems may once again find themselves short-staffed. As a result of these risks, sub-contractors will face a difficult balancing act and may prefer to hold onto staff, so as to avoid higher costs further down the line.

CONSTRUCTION JOBS STILL LOWER PRE-PANDEMIC

Source: ONS



Another problem with a reduction in the size of economy this year, and a rebound next year, is what it means for business insolvencies. Throughout 2022, construction insolvencies were high, and falling workloads will do nothing to help. Once again, contactors will need to be on top of their supply chain, selecting and managing them carefully. However, while this advice is fairly basic, a recovery also poses challenges. Insolvencies mean there are fewer players in the market, reducing competition. Once market conditions improve, those remaining may be in a position to increase their margins, adding to tender price inflation. There is also a common problem coming out of a recession, where there may be another jump in insolvencies. Firms who manage to hobble through a period of negative growth sometimes find that they don't have the necessary capital to recover, overextend themselves thinking profits will return, and end up facing more problems. As a result, even if construction output starts to rise, project teams cannot become complacent when managing the supply chain.

A general election looms

As we reach the end of 2024, we will also be nearing another general election. Needing to be held no later than January 2025, this will have potentially important implications for the construction industry next year. In 2019, at the time of the last election, one of the main reasons for the Conservative Party's sizeable majority was its narrative around levelling up. Covid may have lessened this as a priority, but the data on public construction spending is nonetheless disappointing. Last year was the non-housing public sector's worst for output since 2002, declining almost 9% and resulting in the sector being approximately a sixth smaller than in 2019. This suggests many of the schools, hospitals and other projects promised are yet to get off the ground. Furthermore, while infrastructure spending has increased considerably, much will have gone towards larger projects such as HS2 and Hinkley Point C, rather than a more even distribution across the country.

A common theme before elections is for the governing party to try and stimulate the economy, induce a feel-good factor and increase their chances of being re-elected. Based on this, it is possible that, as 2023 progresses, they will find additional money in order for these schemes to be in full swing by next year. The March Budget contained few giveaways for the construction industry, with a more optimistic interpretation of this being that the government is holding back in order to release funding closer to the next election. While there may not be enough time for the schemes to be complete ahead of a general election, the government would prefer it if they were helping drive growth in the economy. At the same time, those looking to 2025 will consider what the next government's plans will be. Despite being a long way from any manifesto, recent pronouncements from both Labour and the Conservatives have shown a commitment to growth across the country. Potentially similar to levelling-up promises, only time will tell whether it results in more money for the regions. If it does, construction should benefit. Construction is also likely to play a key part in on of Labour's other pledges, where they aim to make Britain a clean energy superpower.

THE IMPORTANCE OF COLLABORATION AND HONEST CONVERSATIONS

Rampant material price inflation over the past two years has underscored the need for all people working on a project to not shy away from the truth. Being completely transparent and revealing risks and changes at an early stage may allow for mitigation strategies which circumvent unnecessary costs, or at the very least limit them. Furthermore, this is an issue that will not go away in the coming year, as insolvencies rise and potential pressures from a recession mount.

Early engagement

If certain aspects of a project are starting to look less credible, the best time at which to discuss them is immediately. Not only does this increase the possibility of finding alternative solutions, but brave conversations also increase trust. By being consistent and honest about a project's difficulties, everyone involved understands where they stand and the most prominent issues at hand. Such honesty may not also offer an immediate payback. It is all too easy for a client to go with the lowest bidder, however, if the bid doesn't correctly price or identify everything in the project, then as the scheme develops, problems will emerge. In such a situation, the client may choose to re-engage with those who were honest at the start, trusting that they fully understand the scope of the project, and can actually complete it as promised.

Aim to provide clarity and certainty

While telling a client that costs are rising is never easy, often there is no way of avoiding the economic reality. No amount of sugar coating can get away from the fact many materials have seen double-digit price increases recently. In the case of certain products, such as steel, it is fairly straightforward to point to commodity indices, proving prices have risen. However, many construction packages will be made-up of a variety of materials and products and, with these, it may be necessary to provide greater levels of information. Some may try to use high levels of general inflation as justification for their own price increases and those doing so may be unhappy about scrutiny. By contrast, those who are confident in their price changes will be much more willing to have conversations about where and why they are seeing movements. The greater the level of detail on offer, the easier it is for a client to understand and be willing to pay any increases. Similarly, a lack of detail may create friction and distrust.

Strategic suppliers

Another way to increase the chances of obtaining honest, accurate and timely information is through proximity to the market. The closer one is to the supply chain, whether that is a contractor, client or consultant, the more likely they are to deliver reliable messages. However, trust takes time to build, and this is where having strategic suppliers, with strong relationships, can be beneficial. Those who are closer to the market and have a wider network of dependable suppliers are likely to have been better placed to weather the recent economic challenges, either through understanding the issues earlier or choosing not to take on specific risks. Feeding this information back to their clients, and up the supply chain, will also allow them to make better decisions.

The added benefit of all of this is if it helps make a project successful. It also makes it much more likely there will be repeat business. Clearly, delivery is vital, but the journey to completion also matters, and anything which can smooth the path is likely to improve one's chances of working together again.

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