# UK MARKET VIEW

## CONSTRUCTION CONTINUES TO GROW BUT CONSIDERABLE HEADWINDS REMAIN

Q3 2023

"The economy continued to struggle over the past quarter, and is likely to persist into 2024. Against this backdrop, the Bank of England has tightened monetary policy further and this is causing significant challenges for construction's largest sector, housing. Inflation may be easing but it is still far too high, and despite construction material prices now falling, the pressure caused from historical increases is still a major issue. With high labour costs, tender prices will continue to grow. Another quarter where there were numerous insolvencies highlights how these problems are feeding through. Fully understanding the supply chain, and the inherent risks within it, is increasingly vital.

One troubling aspect from recent data releases was the fall in new orders. In particular, Q2 showed much weaker planned public expenditure. The recent news around RAAC has created significant anxiety that will necessitate additional spending in order to maintain existing plans for output; several government departments were already aware of the issue and drawing up plans to address the issue, as were several major private sector clients. It is not yet clear whether this will be new spending or sourced from existing capital budgets. Given the fiscal squeeze caused by higher interest rates and inflation, it was always likely that public spending would come under pressure. If Q3 sees another very low set of new orders data, we may need to lower our tender price forecasts. An impending general election only adds to market unpredictability."

**Andy Beard**
Global Head of Cost and Commercial Management

| | 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.

**Material prices are now...**

**2%**

**lower than they were a year ago.**

**New orders were...**

**7%**

**lower in Q2 than Q1, with particularly large declines in government funded sectors.**

**GDP increased...**

**0.2%**

**in the second quarter as the economy continued to grow slowly**

**Construction output rose...**

**0.3%**

**but this was due to repair and maintenance, and all new work output declined for the second quarter in a row.**

**Pressures from labour costs eased only slightly as the annual rate of regular construction pay slowed from 6.5% to...**

**5.8%**

# SETTING THE SCENE

The last three months have seen the economy continue to just about grow. GDP rose 0.2% in the second quarter, with construction output rising 0.3%. It is hard to describe such performance as anything better than modest, and it appears doubtful that conditions will pick-up anytime soon. While pay is now growing faster than inflation, real incomes are lower than they were at the end of 2021. With interest rates continuing to rise, and a growing number of households remortgaging at higher rates, pressures on spending remain problematic. None of this is surprising, and nothing has noticeably improved or worsened since our previous report. As a result, and against such a backdrop, we are leaving our tender price forecasts unchanged.

This is not to say that we are complacent about the challenges facing construction. Notably, new orders had another weak quarter, and this does create renewed doubts about how the industry will fare in 2024. Given the cost-of-living crisis, rising interest rate rises and the government's fiscal caution, getting new contracts over the line is becoming increasingly difficult. However, in expecting such a slowdown, it justifies our forecast that tender prices will ease to between 2% and 2.5% next year. Yet, with a particularly noticeable drop in new orders for infrastructure and the non-housing public sector, there is a clear downside risk to these forecasts. If the public sector scales back further, alongside the well-known issues facing housing and commercial developments, the potential for significant competition between contractors will grow. There is already some evidence of this happening according to the S&P Global / CIPS UK Construction PMI. While still reporting rising prices, the survey mentions that, in some cases, competition is leading to easier negotiations.

Whereas total construction output has risen this year, all new work is declining, albeit only 0.1% in Q2. Lower new orders point to further weakness on this front, but it will require a severe downturn for inflationary pressures to completely end. Firstly, even with parts of the industry seeing significant declines, labour shortages are a major issue. Vacancies are still very high and pay growth, while not as high as in Q1, is still considerable. As well as reflecting those choosing to retire early, and Brexit, it is also not always easy to move from one part of construction to another. Secondly, despite material prices now being lower than 12 months ago, prices have actually risen since the start of 2023. Long-term hedges mean that lower energy prices are largely yet to feed through, so lower prices will take time to become widespread. So far, only steel and wood, two products which saw some of the largest rises, are falling. A final reason not to expect prices to drop is that many companies across the supply chain will be trying to recoup lost margins. Having seen these squeezed because of higher inflation, even if input prices do fall, firms may be reluctant to pass on the full amount, as they try to return to previous levels of profitability.

For some firms, the hit to margins has been too much and, unfortunately, insolvencies continue to plague the industry. Rising to a record high in the second quarter, Buckingham Group is the latest high profile casualty. The recent small reduction in material prices is likely to do little to help those in fixed price contracts and, with labour shortages still a major issue, as well as many likely to be seeing a drop in pipelines, such challenges will persist. The ongoing fragility of the supply chain again underscores the importance of procuring the right firms, who have the capability and financial strength to deliver a project successfully. Similarly, there is a need to keep a tight control of costs, being aware of the weakness of some firms, and the sorts of behaviours this may cause. Eventually, these issues may lead to less competition and higher tender prices but, for the moment, the problems will only act to dampen them.

In the final part of our report, we take a closer look at several recent government decisions. Decisions around retrofit and second staircases may hinder output, while as the House of Lords have rejected nutrient neutrality plans, it now requires new legislation. Even if it eventually passes, it will take time before housebuilders, who are much more concerned around economic fundamentals, can benefit.

# WEAK NEW ORDERS POSE RISK FOR 2024

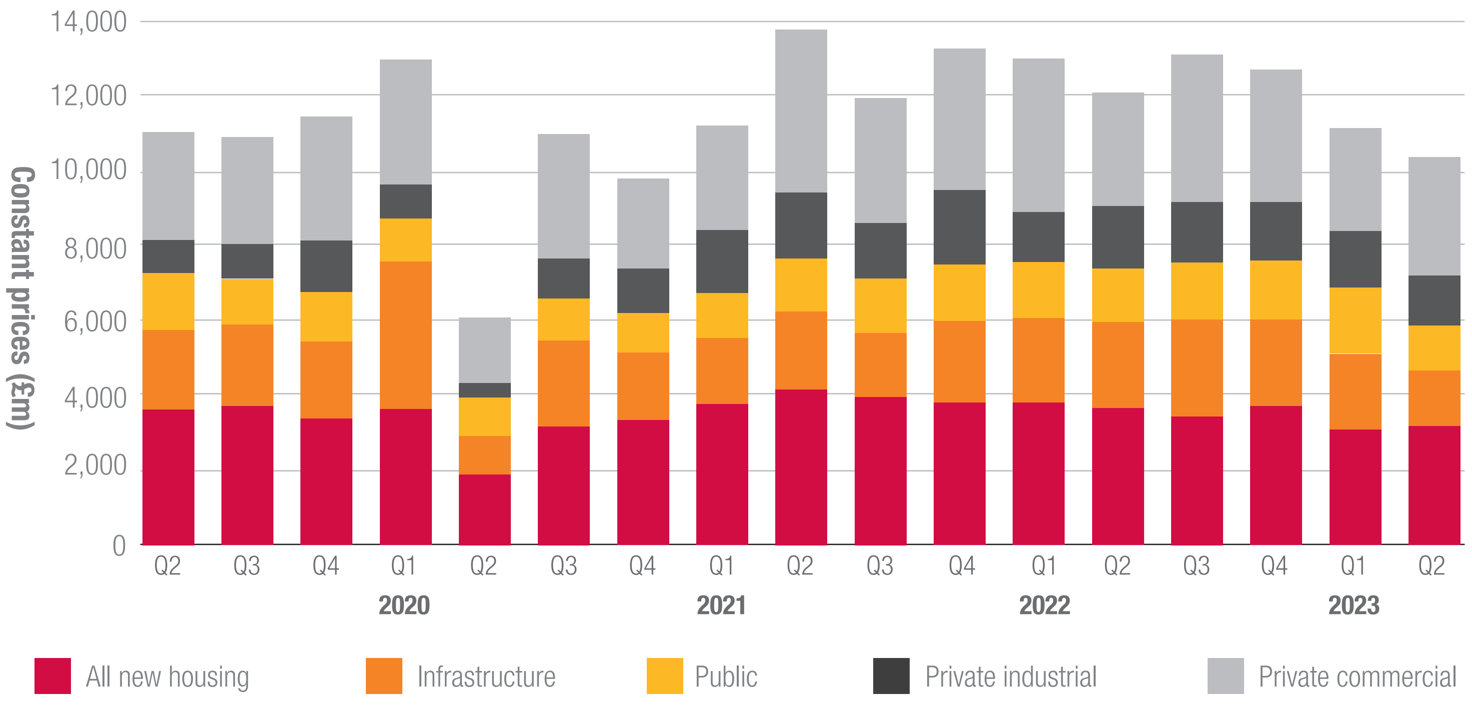
## New orders

Excluding the pandemic, Q2 was the worst quarter for new orders since 2012. Declining 7% relative to the first quarter, they were also down around 18% compared to a year ago, with all sectors facing some sort of challenge. The most worrisome aspects of the figures surround the infrastructure and public non-housing sectors. Not only did these two see the largest reductions and drive the overall weakness, but they are also the part of the industry which one might hope to hold up. With the infrastructure drop – the third quarterly decline in a row – coming from its public portion (most notably roads), the perception that the government is putting the brakes on spending has been heightened. Similarly, public non-housing, which has had a number of strong quarters recently, declined by around a third. For both sectors, it may simply be a case of the natural volatility, typical in the data. However, due to the issues surrounding budgets, there is no guarantee of a rebound.

Total housing grew 3.9% in the second quarter, but this was from Q1's very low level. Only being marginally greater than three months ago still leaves the sector at one of its weakest levels in over a decade. On a moving four-quarter basis, which avoids some of the volatility and gives a better guide to how conditions are changing, total new housing orders were down 11.8% compared to Q2 2022. While not inconsiderable, and output is clearly taking a hit, it is nothing like the slowdown that happened in the aftermath of the global financial crisis, when peak to trough saw the sector more than halving. Ongoing rising interest rates will do little to help the housing sector recover, but the so-far-limited drop in prices, as well as unmet demand, will prevent the sector entering into complete freefall. The private commercial sector also saw new orders rise in Q2. As with housing, Q1 was an especially bad quarter and, despite a relatively healthy 14.4% increase, it is difficult to get too optimistic about a sector still trying to adapt to the changes triggered by Covid, such as hybrid working. Additionally, as with housing, planning, inflation and high interest rates are deterring spending.

NEW ORDERS FALL AGAIN

Source: ONS



## Construction output

A very strong June offset any decline caused by the King's Coronation and helped push construction output up 0.3% in Q2. This is only slightly slower than the first quarter's growth of 0.4%, and once again shows the wider industry is just about coping against the challenging economic backdrop. However, as in Q1, there was a fall in all new work, whereas the repair and maintenance sector rose. Looking at the combined figures for the first half of the year, new work has fallen 1.5%. Meanwhile, repair and maintenance is up 5.5%. As a result, the industry has risen 1.2% in the first six months of the year. However, for tender prices, it is new work which matters, and its weakness is likely to be keeping subcontractors keen.

As usual, there is considerable differences in how the individual sub-sectors have performed. Key to the sluggish recent growth is the housing sector, down 2.9% in Q2 and almost 8% lower than in Q2 2022. Were we to take out the housing sector, all new work suddenly looks a lot stronger. Excluding all new work's largest sector, and saying it's growing isn't just an attempt to manipulate the statistics. Housing is a sector facing a variety of problems, many of which are putting pressure on selling prices. In addition, and unlike the commercial sector, stopping new developments can happen much quicker, and its fairly quick recovery after the pandemic has left it with plenty of scope to decline. The fact that, once we exclude the housing sector, all new work output has increased 1.7% over the last quarter, and is 6.4% up on a year ago, shows how some parts of the industry are enjoying robust growth.

This growth is most notable in the infrastructure sector. Rising 6.1% in Q2, and up 11.3% over the last year, it has rebounded convincingly from the slowdown it went through 18 months ago. While pushing back parts of HS2, and the recent lack of new orders are a worry, for the time being, growth is strong. A similar, if not quite so bright story is in the non-housing public sector. Rising 2.4% in Q2, and 5.8% over 12 months, the latest new orders figure also put doubts on whether this will be able to continue.

## Interest rates

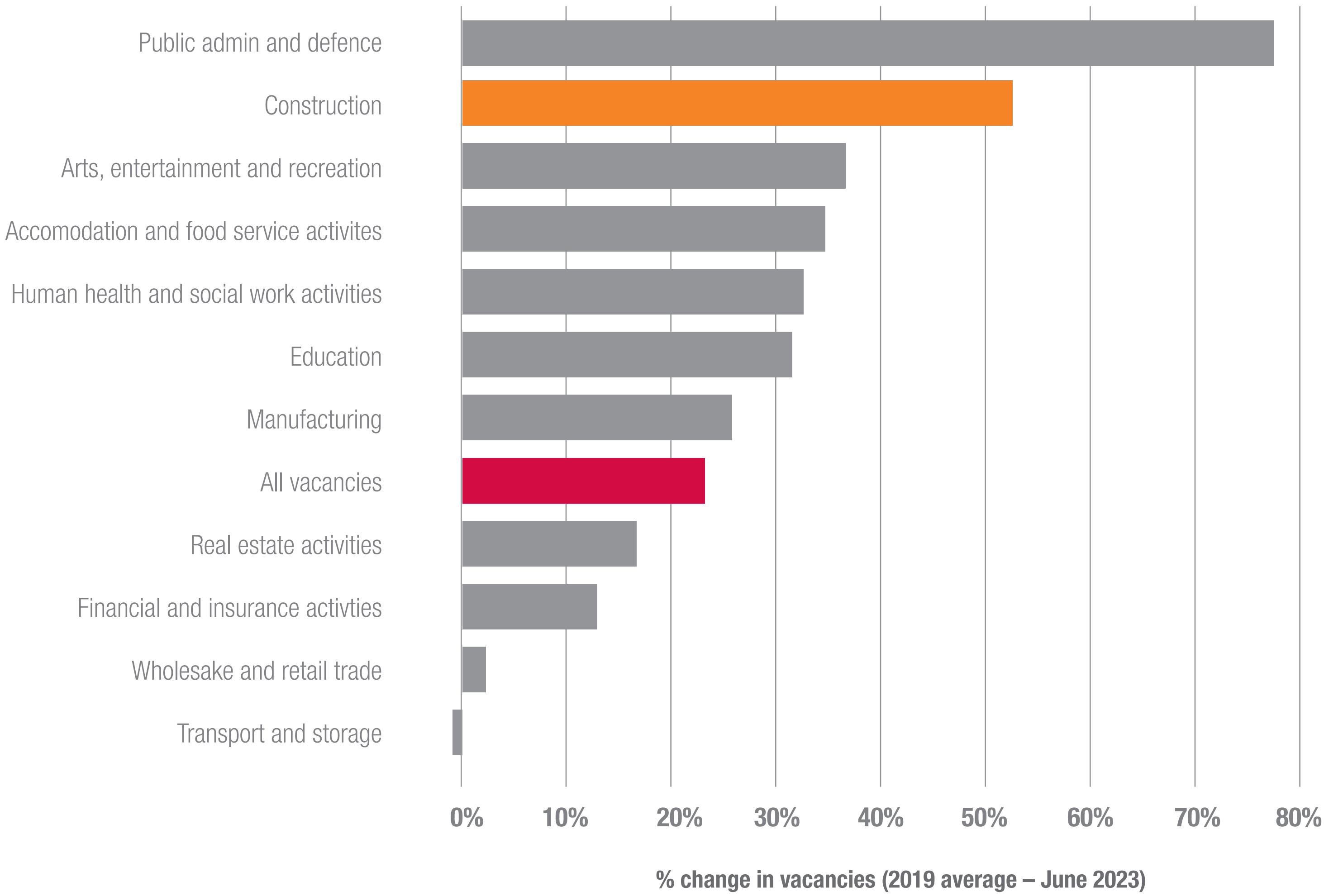
Interest rates have now risen to 5.25%, and despite the Bank's September decision to leave them unchanged suggesting we may have reached a peak, if inflation doesn't come down rapidly in the coming months, another increase is possible. While the 50 basis point increase in June was larger than the Bank of England's usual 0.25% shifts, overall, rates are still moving in the direction anticipated earlier in the year. CPI inflation is still far too high for the Bank's liking, nowhere near their target of 2%. This means an ongoing likelihood of further rises. Just as importantly as the peak interest rate is how quickly the MPC starts to bring them down. Current forecasts point to this being a slow process, with the Treasury's collection of independent forecasts predicting that, at the end of 2024, they will still be very close to 5%. As such, it is difficult to see those reliant on borrowing – most importantly the housing and private commercial sectors – realising any easing on this part of their viability equations until the following year at the earliest. While pressure from other factors, such as input costs, should alleviate much sooner, until there is a greater retreat in rates, the problems facing these two sectors will remain.

## Labour costs

Over the past three months, regular construction wage costs have started to ease, but the rate of growth is only coming down slowly. From annual growth of 6.5% in March, the pace has slipped to 5.8% in June. Nonetheless, wages in Q2 were 1.4% higher than in the first quarter. While this may have been slower than the 2.2% rate seen three months ago, it still leaves pay rising much faster than is usual. Construction vacancies, which came down considerably in the second half of last year, also saw a minimal decline; falling from 41,000 to 40,000 in the three months to July is a negligible drop. Comparing construction to other sectors with vacancies over 10,000, only public administration and defence has seen openings increase by more compared to the 2019 average. Vacancies have been coming down across the economy. Yet, while the whole economy now only has vacancies 23% higher than before the pandemic in 2019, for construction, the increase is over 50%. Until vacancies fall further, almost certainly due to the market slowing, employees will continue to be in a position to push for pay rises.

## CONSTRUCTION VACANCIES STILL VERY HIGH

Source: ONS




## Material Costs

Relative to a year ago, construction materials are now falling in price. In June, the annual inflation rate of the 'all work construction material price index' slipped to -2%. However, this deflation comes with a number of caveats. Most importantly are the previous, outsized inflation rates. Compared to January 2022, prices are up 11.8%, while also being 35.6% greater than January 2021. Additionally, much of the weakness in recent prices came in the second half of last year. While prices did fall month-on-month in June, this was the first decline since January. That the index is greater than it was at the end of last year may be due to higher wages, with growth of manufacturing pay above 8%. It also gives another sign that demand for construction products is still healthy and not weakening at such levels which would force manufacturers into large cuts. One final sign that prices are holding up comes from the specific materials the Department for Business and Trade looks at. Of these 28 products, nine still have an annual inflation rate of over 10%, and only five have seen their prices fall. Because the falls include reductions of over 25% in some steel and wood products, the overall index is lower. But, again, it shows in general, prices are proving sticky in coming down.

# CHINA'S REOPENING A LETDOWN FOR COMMODITIES

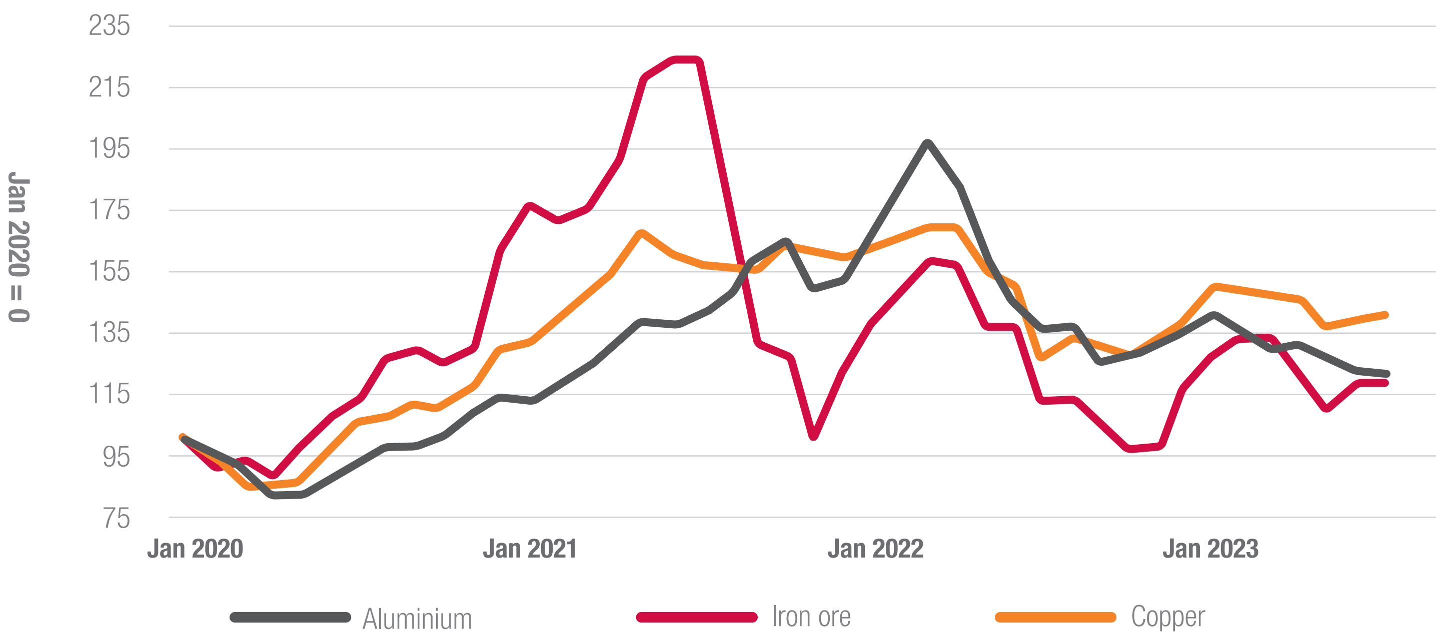
Earlier in the year, we discussed how China reopening was going to play an important role in the path of material prices. So far, from a UK construction perspective, China's relatively weak recovery is good news. GDP in China is now forecast to grow less than 5% this year (Beijing's official target for growth) and consumer prices are falling. As well as these wider economic problems, the property sector, which demands huge amounts of steel and other commodities, is struggling. Alongside recent negative news around Country Garden, one of China's largest developers, new housing starts have fallen significantly since 2021. Unsurprisingly, such problems are negatively affecting many global commodity prices.

Iron, copper, and aluminium are all lower than they were in January. As well as the problems in China, demand in Europe is also poor. For all three metals, the S&P Global Users PMI has shown conditions worsening throughout the first half of the year. As in the UK, higher energy costs have hit growth and the European Central Bank has been raising rates. The largest European economy, Germany, is in a recession, with the manufacturing sector under the most strain. In the wake of a lack of demand, these three key metal prices have sunk. While they are still higher than the start of 2020, the risk of them surging again, as we feared earlier in the year, appears to have rescinded. This should help provide confidence to clients and contractors worried about material price volatility.

One commodity which has rebounded recently is oil. The Chinese economy may be weak, but many others are proving to grow more strongly than expected. Added to greater demand, is lower supply. Earlier in the year, Opec+ agreed to cut production but, with this not having the desired effect on prices, Saudi Arabia made a further voluntary cut. Combined, these two factors are leading to a tightening in the market and Brent crude oil prices have now risen from a low of around US$73 a barrel to over US$90 . While this move only takes prices back to levels seen earlier in the year, and the pound's appreciation should soften the increase, petrol prices were rising in August. This is not to say the increase will have a noticeable impact on either tender prices or other inflation figures, but it does give manufacturers another reason not to cut prices.

## WEAKER GLOBAL METAL PRICES

Source: World Bank



# TOO LITTLE AND TOO MUCH GOVERNMENT INTEREVENTION

As discussed, the latest new orders numbers show a large drop in public funded projects. While this is just one quarter, which will take time to affect output, and despite infrastructure and non-public housing being two the fastest growing sectors within new work in Q2, it does signify an extensive risk going forward. Furthermore, the potential slowdown has been something we have been concerned about for a while. Ever since inflation started shooting up and the government chose not to respond in-kind – leaving budgets the same in nominal terms, but letting them drop in real terms – budgetary pressures have risen. Delivering the same volume of projects without adjusting for higher prices is impossible. Alongside this, the government is also facing a squeeze as higher interest rates mean their cost of borrowing has increased. Even so, recent figures from the ONS did show that the government's position is better than the OBR forecast; a result of larger tax receipts. However, while benefitting from rising wages and fiscal drag, expenditure is still greater than income, and the higher borrowing costs will give little room for manoeuvre in the Autumn Statement. With the house building sector facing a slump, increased government spending is highly desirable to help sustain the industry.

As well as new orders figures suggesting government spending on construction may decline, recent months have also seen a number of announcements cause consternation in the sector. The first of these relates to a decision in July about not allowing Marks & Spencer to demolish and rebuild its property on Oxford Street. Going against Westminster Council's planning decision, Secretary of State for the Department for Levelling Up, Housing and Communities, Michael Gove, concluded that the new building wouldn't do enough to reuse existing resources or support the transition to a low carbon future. This is in spite of the plans saying the new building would use less than a quarter of the energy than the existing one does. If life for the high-street isn't hard enough already, blocking improvements to flagship stores, especially if less prestigious ones start to suffer the same fate, will only make matters worse.

This is not to say that refurbishment should not now be the preferred option. In many cases it should, and in all cases, it should be considered. Recently, Mace published a report looking at the importance of refurbishment and retrofitting. Offering a number of proposals for government, these included the need for greater certainty, new standards, mandates and best practices, and more collaboration between government, developers and contractors. Nonetheless, where refurbishment is not appropriate, and M&S argues this includes its store, by not allowing a more comprehensive overhaul, some buildings will run the risk of becoming stranded. An even greater risk for owners is if knocking a building down and rebuilding it is not viable. While this is unlikely to be the case for properties on Oxford Street, this could happen in some areas, where returns are much lower.

Owners of stranded assets will lose out significantly and will need to spend much of the next decade thinking about ways in which to avoid doing so. Not only are regulations on a building's energy performance becoming increasingly tight, but it is now of much greater importance for occupiers. Such changes are pushing landlords and developers into looking far more into the whole life carbon cost of projects. This means analysing not only the production of materials and construction, but operational emissions and end of life. It is becoming necessary to reassess what an optimal asset looks like, and how the different life-cycle phases should fit together. Such strategies change risk profiles, however. Spending more upfront, in order to build more energy efficient buildings, requires greater initial financing. Such buildings currently pay higher yields, but these could fall as newer, ever more efficient properties are built, and it is possible depreciation will happen more rapidly. Moreover, with higher interest rates, larger capital expenditures create problems with paying back loans. Developers therefore have a difficult balancing act even before thinking about how hybrid working is creating another paradigm shift.

Along with Mr Gove intervening in commercial buildings, in July he announced a rule saying that all new residential properties over 18 metres tall would require a second staircase. Previously, the limit for second staircases had been set at 30 metres, and this new change will negatively affect a number of schemes, particularly in London. This restriction was already in place in Scotland, and as a share of total properties in England, flats only accounted for 19% in the financial year ending in 2023. However, this share rises to 96% in London.  While not all flats will have heights of over 18 metres, it does highlight a stark difference in property types across the country. For schemes built by housing associations, flats are even more prevalent and this new rule is only likely to weaken the response to the dire need for more affordable housing. One government report calculated that over 60% of residential buildings over 18 metres are in London. Taking this existing share of properties as a reasonable guide for future projects, we again see just how disproportionately the new rule will affect the capital. With the viability of housing under extreme pressures, requiring an additional staircase, and all the extra costs involved with it, will only worsen the assessments. Already we were forecasting that, in the short-term, London would see lower tender price inflation than the national average, and this will only exacerbate the challenges.

One recent story where the government hoped changing policy could boost housebuilding is with regards to nutrient neutrality rules. It was suggested the regulations, which previously stopped new properties from being built if they might lead to excess nitrate and phosphate river pollution, had prevented up to 150,000 homes from being built. However, having been defeated in the House of Lords, to push the policy forward will need the implementation of a new Bill in the House of Commons, which requires changes to legislation. This process, if it happens, would take time, and it is currently unclear whether it will happen. There is also no guarantee the government's claims it would allow 100,000 homes to be built by the end of the decade would be realised. Housebuilders will often have a number of sites they can build out and, rather than build more homes, they may choose to use sites currently held back by the nutrient rules as an alternative to other possible sites. Were it simply a case of 100,000 extra new homes by the end of the decade, it would be roughly 14,000 extra homes a year. Last year in England, there were 177,000 new homes built, so this would be a noticeable increase. However, housebuilders may prefer not to increase the homes they build by this much, and that's before we look at questions surrounding the market's capacity to deliver more homes, and the current problems with falling prices. This decision also comes with a fair amount of controversy and, despite the government announcing extra funding to offset the changes, the risk is that river pollution will rise. Similar to other recent decisions, there is a trade-off between the environmental impact and the urgent need for new properties.

Speculation in the media that the Birmingham to Manchester leg of HS2 will be scrapped is problematic. As well as having a direct impact on construction output, it creates all sorts of wider questions around infrastructure in this country and the Conservative government's stated ambition on levelling-up. Having already scrapped the eastern leg from Birmingham to Leeds, this apparent further scaling back leaves even fewer gains for the North and other areas that were supposed to be the prime beneficiaries of the 2019 Conservative manifesto. It is clear that many business leaders from across the country remain in support of the HS2 link to Manchester. Moreover, the sector has repeatedly called for certainty and consistency across the public sector, infrastructure and construction pipelines. Potentially more harmful than the effect of reducing pipelines is the uncertainty and lack of faith the decision causes. If businesses don't believe that proposed work will happen, they won't have the confidence to invest in training, creating new jobs and growth. Given the seriousness of skills shortages in the industry and desire to improve productivity, such a set-back, and the associated damage it will do to investment strategies, is highly undesirable.

Rishi Sunak's net zero policy announcement also shows a government indifferent to business uncertainty. In this case, the decision to push back the ban on petrol cars hurts the automotive sector. For construction, there was an increase in the subsidies available to upgrade domestic heat systems, but no corresponding increase in the size of the fund. More importantly, there was nothing new around insulating homes. More needs to be done on this, and improving insulation is sorely needed to help bring down emissions and energy bills.

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