

UK MARKET VIEW

TENDER PRICES SHOULD
RISE IN 2023, EVEN IF
OUTPUT DECLINES



Q4 2022



In a challenging market and with increasing inflation and further pressure of the cost-of-living, the industry faces a difficult year ahead. However, the construction industry's moderate output growth and increase in new orders is an optimistic indicator for the industry to remain resilient compared with other sectors.

The industry is likely to face obstacles in terms of material cost pressures and the impact of inflation on profit margins. Against this backdrop, it's key that clients and consultants continue to prioritise their sustainability goals



Andy Beard

Global Cost & Commercial Practice Lead for Consult, Mace

	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.



Construction output avoided the same fate of the wider economy, growing...

0.6%

in Q3.



GDP fell...

0.2%

in the third quarter, and it looks likely that the economy is now in a recession.



A solid set of new orders, which rose...

6.4%

should help maintain pipelines as the economy weakens.



The Bank of England continues to force up interest rates, and they now stand at...

3.5%



Material prices had their first monthly drop in over two years in August as the annual rate of growth eased from 26.8% in June to...

16.7%

in September.

SETTING THE SCENE

After another disruptive quarter, which contained a range of issues adding to business uncertainty, we have cut our forecast for tender prices in 2023. It seems highly likely that the UK is already in a recession and that GDP will fall in 2023. For the moment, we do not expect tender prices to drop into negative territory, but this is not impossible. Despite GDP declining in Q3, potentially marking the start of a recession, construction output rose a respectable 0.6%. New orders rising by 6.4% also suggests the industry is entering the recession with a moderately healthy pipeline.

The output of all new construction work remains marginally lower than where it was back in Q4 2019. The non-housing public sector and private commercial sector are two notable laggards. With construction vacancies rising to 49,000 in September, they equalled March's record high, and helped keep construction pay growth above 5%. However, this positivity in the labour market should reverse as the market tightens. A final issue that a recession might alleviate is material prices. Even if they only rose 2.4% in Q3 and in September had their first month-on-month drop in over two years, annual material price inflation is still very high, having risen by over 40% since the pandemic. Unfortunately, the significant number of insolvencies in each of the first three quarters of the year implies that the damage from higher material costs is already being felt.

Financing costs are a growing problem. The era of low interest rates, which is likely to have encouraged speculative developments as well as increasing real estate values, is now over and without it, some projects may no longer get the green light. With the Bank of England having consistently raised the base rate over the past year, it now stands at 3.5%. Borrowing costs for mortgage holders and for developers are even higher, leading to expectations of both house and commercial prices starting to fall, which may dampen construction demand.

One of the main reasons for reducing our forecast is the potential for a slump in the housing market. As the largest sector in construction, a reduction in residential activity will have an outsized effect on the industry, dragging down demand for materials and workers. With many forecasters, including the Office for Budget Responsibility (OBR), predicting a fall in house prices, the Market View takes a more in-depth look at what this means for housebuilding. While housing output continues to grow, and the latest figure for housing starts corresponding to Q2 was remarkably strong, it is difficult to reach a conclusion other than that the sector will face a tough couple of years.

Another challenge for the industry will come from sectors reliant on public spending. On the bright side, markets treated November's Autumn Statement treated with indifference. This meant it was a long way away from September's mini-Budget which resulted in the pound collapsing and gilts soaring. However, promises of fiscal discipline may not benefit the construction industry. With inflation so high, simply keeping various spending commitments to previously agreed cash levels will result in substantial real terms declines. With HMT enforcing strict budgetary control, if budgets are exceeded due to inflation or scope creep, then savings need to be made elsewhere. This likely means some public sector projects will inevitably slow down or be paused. Alongside the Autumn Statement came several sobering forecasts from the OBR, and the final section of the report covers both.

One area where growth will hopefully not slow is in relation to projects which can help lower carbon emissions. If anything, the issues raised at COP 27 and the worsening economic climate are justifications for a redoubling of efforts. Climate goals should help support the infrastructure sector and projects such as wind farms, but residential and commercial will also carry on benefiting as retrofitting becomes ever more attractive. For clients and consultants alike, it is necessary that at a time when there is pressure to control costs, thought goes into how best to achieve sustainability goals.

SOLID QUARTER FOR NEW ORDERS AND OUTPUT RISE

New orders

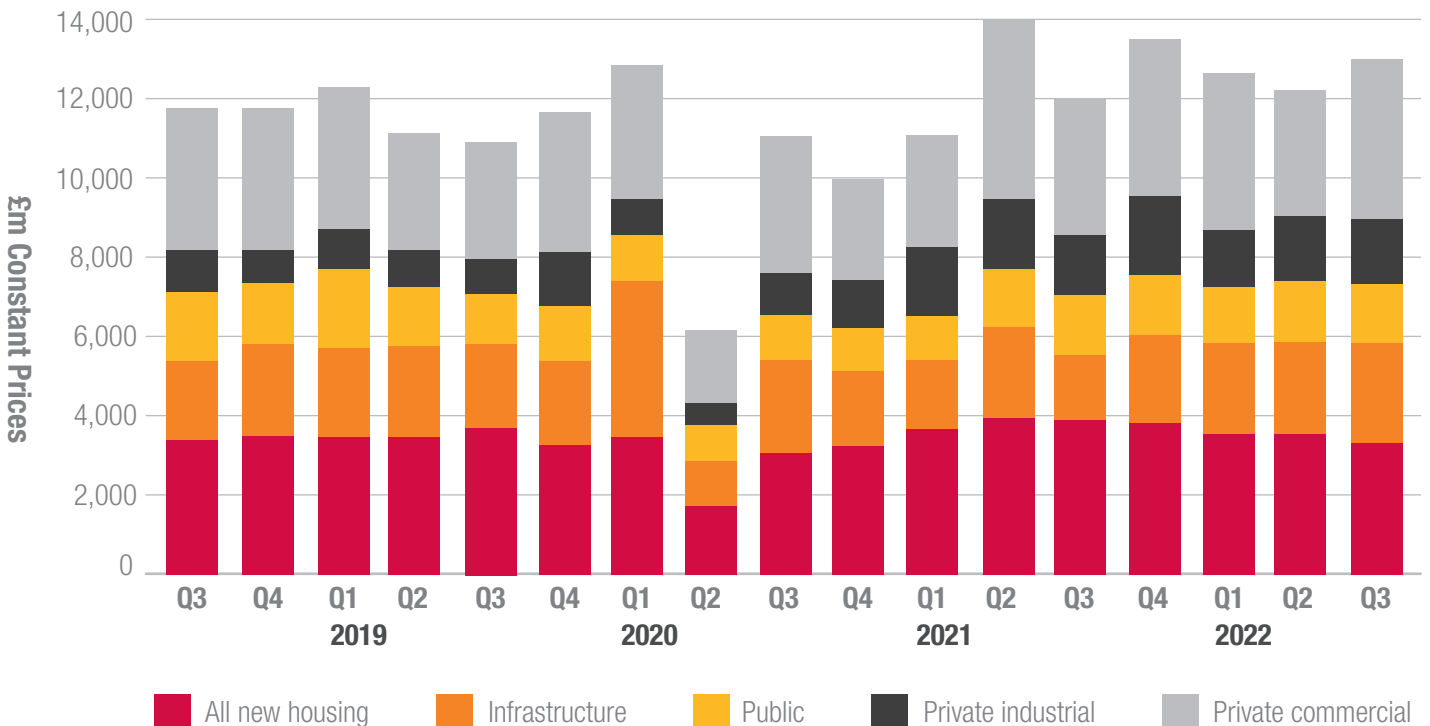
The Q3 new orders data release showed few signs of the economic challenges facing the UK. Rising by more than 6% compared to the second quarter, it was the highest figure of the year so far and will have bolstered pipelines. Assuming we are already in a recession, and if these projects can move easily from a signed contract to starting on site, the quarter could prove very important in providing output some resilience this year. Furthermore, the fourth quarter also appears to have got off to a good start, with Barbour ABI who help prepare the ONS data reporting a very strong October.

Key to the strong showing was a surge in new orders in the private commercial sector, most notably offices. Overall, the sector rose almost 30% in the quarter and other than one period last year, it was private commercial's best performance since Q2 2016, just before the Brexit referendum. This sector is unusually volatile at the moment, causing much of the weakness in Q2's new order. Offices in particular were of concern based on the previous data, but these latest numbers show robust demand. It was also the infrastructure sector's best quarter since the pandemic. Along with spending on roads, which continues to be very strong, it was an exceptional quarter for electricity.

Of greater concern is housing. Public housing new orders fell 25%, with private housing down 3.6%, the fifth quarter in a row it has declined. One challenging thing about this data is trying to reconcile it with the latest number of new housing starts. In England in Q2, housing starts jumped by more than 20%, having their best quarter in more than 20 years. Given the difficult economic environment, as our next section discusses in some detail, it would seem more likely that housing starts in Q2 are a blip and output in the sector will shrink in 2023.

ROBUST NEW ORDERS

Source:ONS



Construction output

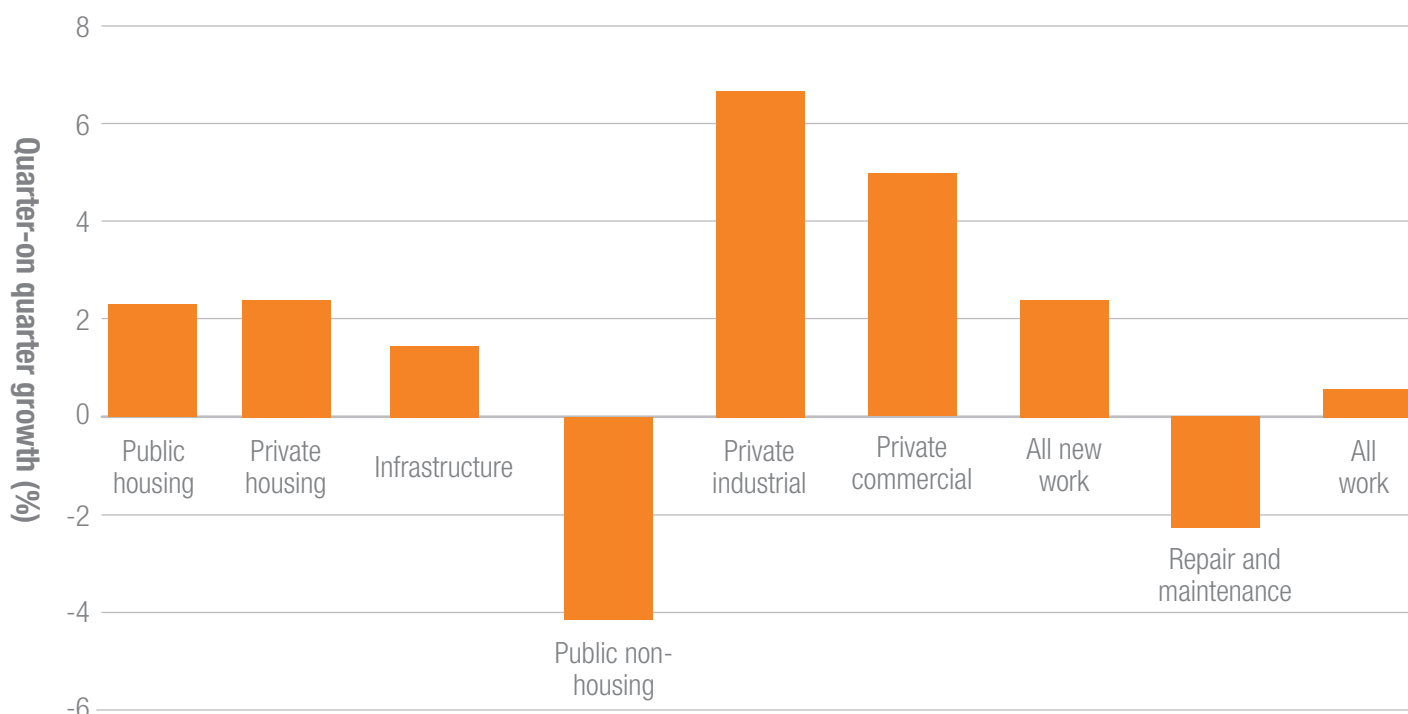
Whereas GDP may have dropped in the third quarter, construction output held up well, rising 0.6%. This included a 0.4% month-on-month increase in September when the additional bank holiday may have been expected to result in a similar outcome to the decline seen in June. Private industrial was once again the best performer, although its still impressive expansion of 6.7% was lower than it has been. Not far behind was the private commercial sector, where output rose 5%. Other than the rebound in Q2 2020, this was its best quarter since 2017. Nonetheless, commercial output is still almost a quarter lower than before the pandemic. Despite some good showings in commercial new orders over the past year, it appears it may be taking more time than usual to get projects onto site.

There was also good news in the infrastructure and housing sectors. Our previous report mentioned that infrastructure had had a good Q2, ending a run of poor out-turns, however the latest data has revised these figures and output actually fell 5.7%. As such, third quarter growth of 1.4% appears modest and the sector is around 10% smaller than a year ago. However,

more importantly than the recent knocks, is it is still far larger than before Covid, and remains an important part of giving the construction sector strength. Meanwhile growth of 2.4% shows good performance from housebuilders in spite of what is likely to be a tough 2023. Unfortunately, it wasn't a perfect sweep of new work categories seeing growth. Output in public non-housing fell 4.2%, is 5.9% smaller than in the third quarter of 2021 and still almost 20% down on its pre-pandemic size. With the fiscal predicament many parts of government are in, it is hard to envision a thawing in conditions.

CONSTRUCTION OUTPUT MANAGES TO GROW IN Q3

Source:ONS



GDP

In shrinking 0.2% in the third quarter, there is now a strong chance that the UK economy is in a recession. Whether this occurs depends on what happens in Q4. With the additional Bank Holiday in September, it is possible that a complete set of working days will prevent the definition of a recession, two consecutive quarters of negative growth, being met. However, one thing that is clear is the economy, and in particular the consumer-facing part of it, is weakening. Retail sales volumes fell 1.9% in Q3 as the cost-of-living crisis started to bite. With conditions only likely to worsen in the coming months, this part of the economy will continue to drag GDP down. Lower output from the manufacturing sector also points to problems. An especially large decline from basic metals and metal products may reflect both weakness from parts of the construction supply chain and mean that sourcing products is more difficult.

Labour costs

Labour costs started to slow in the third quarter with regular construction pay rising 0.9%. This was the weakest growth rate of year, noticeably lower than Q1's 1.9% growth and Q2's 2.2%. That construction bonuses have eased, albeit from significant levels, in both of the last two quarters adds to the idea that some firms have taken their foot off the pedal when trying to bring in and keep employees. However, given vacancies have picked-up again, equalling their record high seen in the spring, and the annual rate of pay growth is 5.4%, the pressures facing employers remain considerable. Whereas looking closely may indicate construction wage pressures starting to cool, this is not the case in services. Annual growth of regular pay in services now stands at 5.9%, which excluding the period immediately after the furlough scheme ended is a record. Additionally, quarterly growth of 1.8% is greater than earlier in the year suggesting mounting issues. That earnings in this part of the economy are intensifying matters, as if fees for architects, project managers, cost consultants and other client teams are going up, accordingly so will the cost of a project.

Material costs

Over the past quarter, material prices appear to have started to stabilise. August was a notable month as for the first time in over two years, prices dropped. Additionally, the 1.4% month-on-month decline was reasonably hefty. While prices did rise again in September, it was a relatively small increase, and it is clear that pressures are nowhere near as bad as they were earlier in the year. As a result of these improvements, the annual rate of inflation of the 'all work construction material price index' has eased from 26.8% to 16.7%. However, this is still a very high inflation figure and relative to the start of 2020, prices are up almost 45%. Even with the price of many global commodities such as steel, iron, copper and lumber slipping in recent months, it will take a far more severe slump for all of the problems caused by higher material prices to end.

Mace is aware of planned price increases of between 10% and 20% for energy intensive products, notably plasterboard and insulation materials, in the first quarter of the year. Even though gas prices have fallen back, with government support for manufacturers set to be less generous from April, inflationary problems are likely to persist.

HOW WILL A FALL IN HOUSE PRICES AFFECT THE RESIDENTIAL SECTOR?

House prices have started to cool. In July 2022 according to ONS data the annual rate of inflation was 15%, and since then they have eased to 12.6%. The latest figure for October, reported a month-on-month increase of 0.3% but it appears since then they may have started falling. Both Halifax and Nationwide, who provide more timely data, are reporting falls in November and December and the expectation is for prices to drop noticeably in 2023. The OBR anticipates they will fall 9% between the end of 2022 and the middle of 2024, including a 4% drop in the second half of 2023. September's mini-Budget did not help matters but even before this there were concerns about the impact falling real wages and rising interest rates would have on house prices this year. Despite conditions settling since the ex-Chancellor's speech, according to the Bank of England, the mortgage rate for a two-year 75% loan-to-value fixed rate mortgage was 6% in October, more than double the level it was at the end of June. Similarly the OBR, who measure a different mortgage figure, now expect rates to reach 5% in the second half of 2023, almost 2 percentage points above what they were forecasting in March.

As well as the OBR anticipating lower prices, falling real wages and higher interest rates help explain why the average of forecasters who provide the Treasury with data on house prices expect them to drop 5% during 2023. Assuming such numbers prove close to being correct, and that house prices do fall to such an extent, then the impact on housebuilding could be stark.

The graph overleaf shows how real house prices and housing starts have changed over the past 40 years. Since the 1980s, there have only been two periods where house prices have noticeably dropped. This happened in the early 1990s, when the UK went through a lengthy recession, and in the late 2000s, following the global financial crisis. In both cases, the impact on construction and the residential sector was highly damaging. From the peak in 1988, to the trough in 1992, private housing starts dropped from 193,000 to 100,000, a decline of almost half. After the global financial crisis, the downturn was both faster and more considerable. In this case starts fell from 160,000 in 2007 to 65,000 in 2009, a peak to trough crash of nearly 60%.

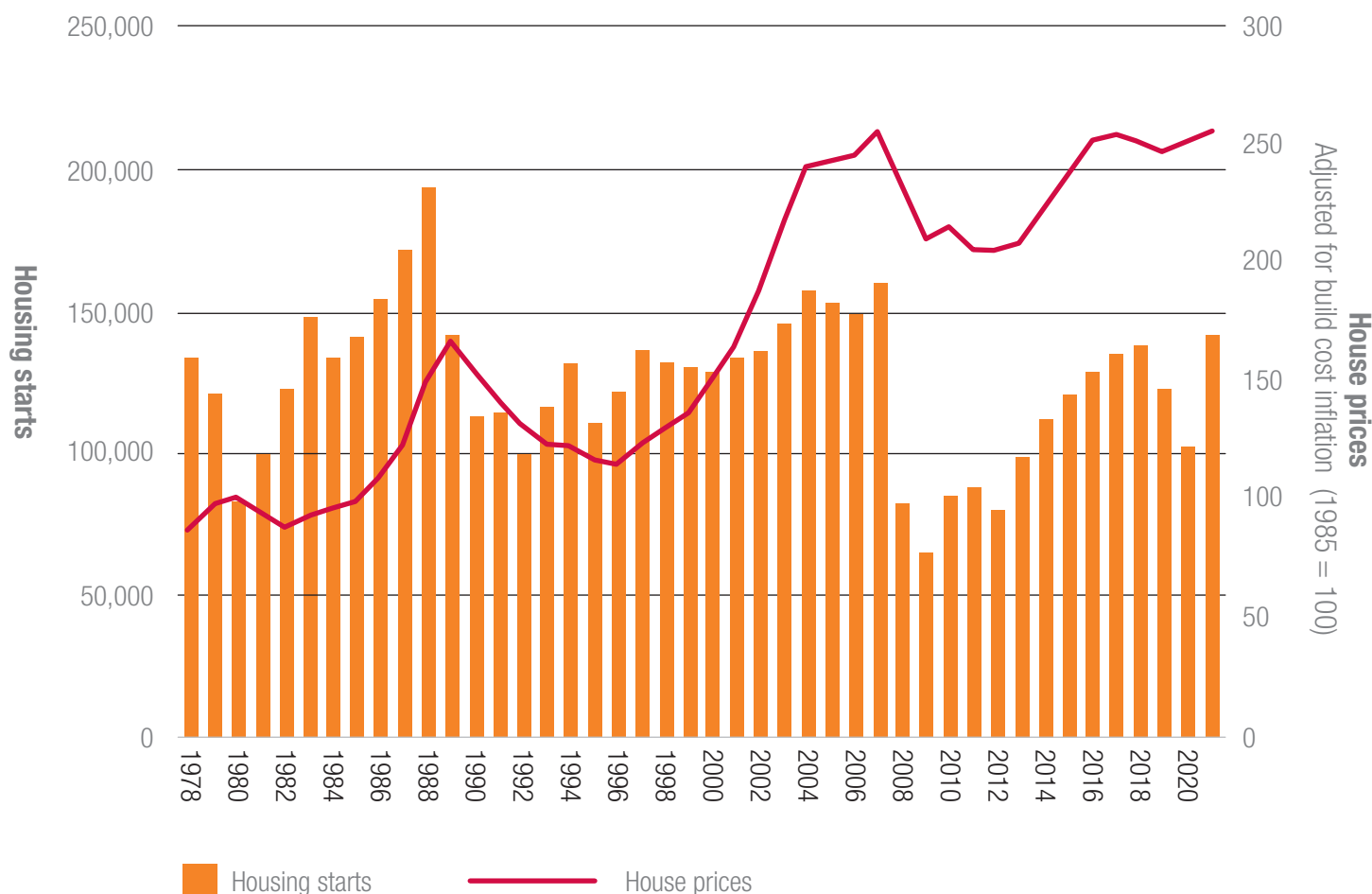
Furthermore, not only does a collapse in house prices mean less building takes place, but any recovery is usually slow. New housing starts have never reached the level they were in 1988 and similarly, since the crash of 2008, housing starts have failed to top where they were in 2007. There are likely to be a number of factors for such sluggishness, however one is particularly concerning for the current construction industry. Recessions commonly result in scarring, with skill losses and employees failing to find new work. Given the difficulties already hurting the industry with regards to skills shortages, such a downturn may only exacerbate the problem.

It is necessary to adjust prices through inflation, which we do using the BCIS General Build Cost Index, as it is profits which matter. Housebuilders will take account of construction costs when determining how much they want to build. Here, there is a double whammy. As discussed at length elsewhere in this report and previous ones, construction costs have risen substantially since the pandemic. While it is too early to see how companies have performed in 2022, Persimmon, the UK's largest housebuilder was making roughly the same profit per unit sale in 2021 as it was in 2019 despite house prices rising 10%.

In recent weeks, Persimmon, along with Barratt Developments and Berkeley Homes, have all highlighted the problems in the market. In response, they are scaling back in new plot purchases, putting projects on pause and brought in hiring freezes. With this potentially just the initial response, conditions could get a lot worse.

HISTORIC HOUSE PRICES AND HOUSING STARTS IN ENGLAND

Source: Department for Levelling Up, Housing and Communities, HM Land Registry, BCIS, Mace Calculations



Regulatory changes

Alongside disincentives from increasing build costs and lower house prices, there are also changes to regulations putting a further squeeze on developers. A recent report from the Home Builders Federation identified 12 new taxes, levies and regulations which combined are due to cost the industry £4.5bn a year. As well as recognising the need for some of these changes, the report calculates that it will add £20,000 to the cost of each new home. Again, looking at Persimmon, this would result in their operational profits dropping almost a third from £66,000 per home. Buyers may not be very sympathetic to the plight of a developer still making nearly £50,000 a home, yet it does help explain why housebuilders' share prices have dropped more than 40% this year. Additionally, as the Home Builders Federation is keen to stress, it is likely to result in fewer houses being built in the coming years.

Another important feature of the graph is the relative lack of relationship between higher prices and starts. Prices have risen substantially whereas the number of starts has not kept pace. Since 1978, even after adjusting for inflation, house prices have nearly tripled while in nominal terms, they are up by over 2,000%. The lack of relationship between prices and building highlights much of what is wrong. That there is not the usual economic mechanism of higher prices resulting in increased supply indicates a broken market that is not functioning in an optimal manner.

For those of a more optimistic nature, there are some reasons why there may be more resilience in housebuilding than in previous recessions. The first, is that unemployment is only forecast to rise a modest amount. The consensus forecast from the Treasury suggests unemployment will reach

4.4% by the end of 2023. Similarly, the OBR expects it to peak at 4.9% in 2024. By contrast after the global financial crisis, unemployment was more than 3 percentage points higher at its peak. Keeping unemployment down is key to preventing forced home sales and putting a lid on any price crash.

Secondly, a report from Savills showed that housebuilders are in a much stronger financial position than in 2007. As a result, they may not need to turn off the taps with regards to building as quickly as they did a decade-and-a-half ago. A third reason as to why many projects may still get the go ahead is due to grant funding. While there was nothing new in the Autumn Statement, there is the ongoing Affordable Homes Programme. This involves over £7bn in support outside London, and a further £4bn of money in the capital, all of which is due to be spent before 2026. Many housing associations and other developers focused on projects which include affordable homes may therefore need to push ahead with their schemes. Finally, there is still much unmet demand for properties and many people still have considerable savings after Covid. This should limit house prices falls and encourage builders to continue going. Despite these reasons, more resilience in output does not mean it won't fall, and it is quite conceivable that the second half of 2022 represents a high watermark.

With property being many households' main source of wealth, any downturn in prices can lead to people feeling poorer and as a result spending less. This is a problem for the wider economy, but for construction, the impact is likely to be much more pernicious. In 2021, new housing accounted for around 40% of total new construction work. Were there to be a similar housing slump to the ones we have discussed, it is highly likely that the wider construction industry would fall into a recession. This is what happened in 2009 and at that time there was a large government stimulus on both infrastructure and in particular the non-housing public sector. With our next section focusing on the challenges these two sectors will face, and higher borrowing costs also affecting the private sector, there are few parts of the industry left to drive growth. Due to all these difficulties, we have cut our forecast for tender prices this year to 2.5% and there are a growing number of downside

risks to this. As this section shows, potentially the biggest is a more severe descent in the housing market than currently forecast.

INFLATION FURTHER UNDERMINES SOMBRE AUTUMN STATEMENT

The poor economic backdrop meant the theme running through the latest big fiscal announcement was one of discipline. Because of the desire to bring borrowing under control, there were a number of unpleasant announcements. Much of the pain may be pushed back to the latter part of the five-year plan, with changes to the next two years roughly neutral. However, from then on fiscal tightening will increase and by 2027-28, it will account for £55bn, around 1.8 % of GDP. For households, the biggest issue may be the decision to freeze tax rates. That thresholds won't increase will mean that even if wages don't rise as fast as inflation, more people will fall into the various tax categories. The OBR estimates this will raise an additional £26bn. As a result, the tax burden is set to reach a post-war high.

One of the many controversial parts of Kwasi Kwarteng's mini-Budget was the decision not to publish a set of economic forecasts prepared by the independent OBR to go along with it. This meant there was no assessment of the impact the fiscal decisions would have. Current Chancellor, Jeremy Hunt, may not have made the same mistake, but given how negative some of the OBR's forecasts were, he may have preferred to have excluded their analysis as well. Most importantly, the OBR believes we are already in a recession, and that the economy will shrink 1.4% this year. This is a slightly worse forecast than the consensus view, and very similar to the Bank of England's. Where the OBR and BoE do differ is in 2024, with the Bank expecting a 1% decline,

against the OBR's more optimistic 1.3% growth. This relative positivity derives from much more confidence about unemployment peaking at a lower level and inflation dropping below zero. If the BoE is correct, and 2024 proves to be another troublesome year for the economy, then we would almost certainly need to revise down our tender price forecasts.

Possibly the most interesting forecast is that inflation will go negative in 2024 for two years. If accurate, it would see prices dropping over 2% and would come about due to declining energy costs and falling tradeable prices. Whether this is occurs may have much to do with developments in the Ukraine war but if goods prices do drop to such an extent, we would probably need to cut our tender price forecasts for 2024 and 2025. The assumptions around lower tradeable prices and an easing in global supply bottlenecks seem more plausible and this is already happening. The Baltic Dry Index, which represents the cost for transporting goods by sea, has dropped a considerable amount since May, and is now around its pre-pandemic levels. While the Construction S&P Global / CIPS UK Construction PMI Survey is still reporting lead times as higher than before the pandemic, conditions have markedly improved from earlier in the year. Similarly, when price increases are taking place, these are usually well sign-posted, with plenty of notice given. Again, this is notably better than six to twelve months ago, when such moves could be incredibly abrupt.

For construction, there was both good and bad news. The good news was that the government reconfirmed its commitment to many large projects such as Sizewell, HS2, Northern Powerhouse Rail and East West Rail. Partly because of the government's expectations management, and partly because capital expenditure spending is easier to cut, there were fears before the Autumn Statement that this would be one area where the pot might shrink.

However, simply keeping capital budgets constant in cash terms is bad news for construction. By not adjusting budgets to reflect the rampant inflation, in real terms, those reliant on the money experience large reductions. That might result either in smaller, less ambitious projects, or a lower number of them. As an example, there was

confirmation that the second round of the Levelling Up Fund would at least match the first-round pool of £1.7bn. In the first round, 105 projects got funding, at an average value of just over £16m each. Given BCIS estimate inflation in the year since to be around 10%, even excluding any inflation over the next year, would mean 10 fewer projects would receive money. Successful bids will be announced before the end of the year, so the slowdown may only become apparent from 2024 onwards, but it is yet more evidence of the problems high inflation causes.

Other parts of the Autumn Statement which could have some effect on construction include the decision to allow housing associations to increase rents by 7%. Lower than their usual increase of CPI + 1%, it gives them more leeway than when another previous Chancellor, George Osborne, stopped rent increases for several years. If private housebuilders do pull back, then limiting the squeeze on housing associations may mean they don't follow the same path.

There was also some protection given to local authorities, but allowing councils to increase taxes by 5%, 2% of which has to go to the social care levy, will only go so far. Such organisations are already under huge pressure and inflation will consume this increase, and their spending on capital projects will almost certainly fall. Hopes about education and health driving growth were also dashed. Given how in previous big fiscal events, there was much fanfare about new hospitals and schools, the lack of mention of further new buildings may be tacit admission of the shelving of these ambitious plans.

PROCUREMENT IN A VOLATILE AND CHANGING MARKET

With so many levers in play currently the choice of procurement route is a complex decision for the buyer.

Historically many clients have chosen Construction Management when prices are at a high and the future trend is unknown or difficult to predict.

Some clients, usually driven by the funders, still desire a fixed price position, off-loading the risk to the contractor and the supply chain. But is this truly an effective or efficient decision?:

- Buying at a high-point can be unaffordable
- Creation/inclusion of a significant quantity of provisional sums or prime cost sums merely greys the edges of a fixed price position and delays the inevitable
- Places a significant pressure down through the supply chain, driving the ultimate risk of supply chain failure
- Creates a challenging post contract environment where behaviours are focused on protection rather placing a positive lens towards successful delivery
- Delays causing the procurement programme being compromised due to late commitment as the contractor fights to procure the works within budget
- Poor quality as the contract and supply chain seek to procure equivalent or similar products that can fail to meet the expected criteria

Second stage contracting can be seen as the compromise position and indeed it should strike the fair compromise between CM and single action contracting, but in the modern world does a traditional procurement strategy give the client with best value for money?

Some thoughts for consideration:

- How effective is the basis of evaluation in the competitive process and how are key risks mitigated?
 - Often disproportionate focus is provided to items like OHP which often have a smaller impact on the overall price
 - An attractive usually shortened programme offered in the first stage can unravel through a second stage negotiation as the assumptions are validated
 - A decision made on a risk percentage that is caveated through contract clarifications or the inevitable change required to align and correct the design as presented
 - Scope creep and or change as the design matures to an expected level of completeness and coordination
 - Price creep beyond the desired cost plan as the true impacts of market conditions are realised through direct supply chain engagement and market testing.
 - Is there enough focus to drive value through the second stage or does a race for affordability erode the opportunities?
- What are the opportunities of modern-day technologies and industry advancements?
 - A shift from construction to production can only truly be realised with the help of the contractor and the supply chain. To realise the wide-ranging benefits of construction to production will often require a re-engineer and re-design if the original design had not properly considered the objective. Too often the desire to embrace construction to production is considered too late in the process and fails to include the right experience and parties earlier enough to positively influence the solution.
 - Improved decision making to find the optimal solution which best meets the project objectives across its whole life cycle. The use of data and evaluation techniques can help to improve the overall solution and better meet the objectives of the project. When costs are rising during the construction phase, having greater confidence the solution is the right solution, optimised in terms of what drives

value and minimises waste, is vital. Wherever possible solutions to reduce the whole life cost of an asset will provide financial benefits in future years.

- Sustainability objectives generally and specifically Net Zero Carbon is in a similar position. These objectives need to be central to the objectives of the project and the design solution from the outset and provide the framework for the project's development. Ideas and solutions to reduce embodied and operational carbon often arrive too late in the project lifecycle and require re-thinking, redesign and will be pressured by time available to review and implement.
- Waste removal and design for production are often not picked up earlier enough in the design process. Examples include top-down construction, logistics and product sourcing, temporary works and product selection. During a period of inflated costs and affordability challenges opportunities to deliver efficiencies in time and cost can often be missed or overlooked.

Is there a better way?

To facilitate current industry best practice and realise the associated productivity and efficiency benefits procurement practices need to consider how they best enable the points highlighted above. An objective from the procurement process should enable the right capabilities, experience and organisations to influence the solution to best meet the overarching objectives of the project or programme. With the right environment, there can be no doubt the cost saved through efficiency of both process and delivery, maximising value of the scheme, accompanied by increased certainty and better management of risk would be a welcome proposition to any stakeholder in a volatile market. Earlier involvement in driving ideas, solutions and value with a positive lens to right first-time design, manufacture and delivery must be a more attractive proposition in the market. Evidence from projects such as the rising factory at East Village shows that early strategic engagement and amalgamation of specialists in their field alongside the design team can drive the most effective and efficient solutions through DfMA. Creating a common agenda for the stakeholders to work together and remove wasted effort and energy places a positive lens on finding solutions that break the norm and make for a faster, safer and better mode of delivery based around certainty, quality and value.

Mace

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

Contacts

Andy Beard
James Donald

andy.beard@macegroup.com
james.donald@macegroup.com