Turner & Townsend

UK market intelligence

Q1 2018

making the **difference**

Economic overview

Chancellor Philip Hammond kicked off his Spring Statement by declaring himself to be feeling "positively Tigger-like" about the state of the economy.

In a speech that was short on policy announcements but long on economic data, Mr Hammond rattled off a list of upbeat economic data; economic growth of 1.7 percent in 2017, and an upward revision of the Office for Budget Responsibility's 2018 growth forecast to 1.5 percent.

However, the official data for the construction industry was far less rosy. Just a few days before the Chancellor's speech, the ONS reported in its three-month on three-month series that construction sector activity fell again in January – its ninth successive decline. Output in January was 3.9 percent below the January 2017 figure, making this the steepest one year fall recorded since March 2013.

Perhaps most worrying of all, new orders slumped by 25.0 percent in the final quarter of 2017. Nevertheless, the strong start to 2017 helped lift the annual total for new orders to £55bn – a 4.3 percent increase on 2016 and the highest total recorded since 2008.

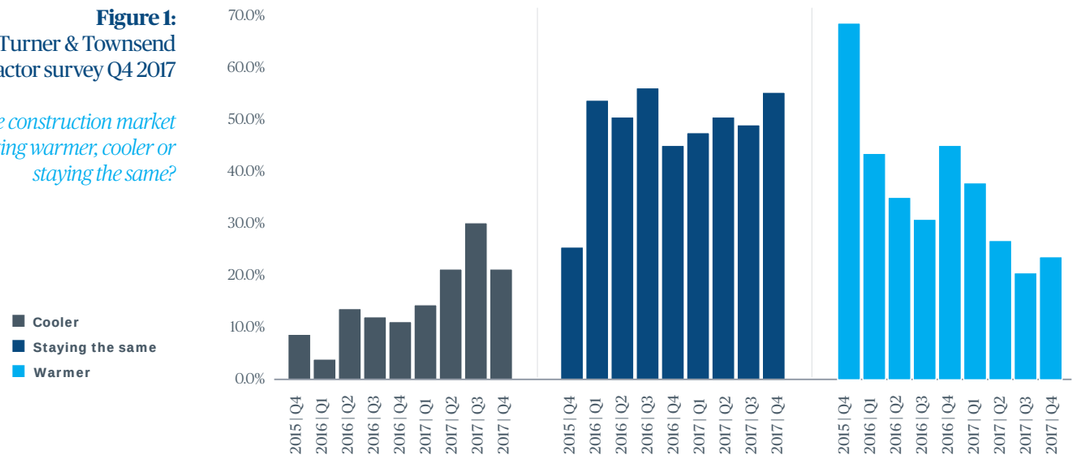
Forward-looking indicators are slightly more positive. After hitting a four-month low in January, the Construction Purchasing Managers' Index rose to 51.4 in February – a figure indicating expansion rather than contraction, but still below the average seen in 2017.

Data collected on the construction industry front line by Turner & Townsend echoes this picture of faltering growth and weak sentiment. The latest edition of our contractor survey found that the market continued to cool in the final quarter of 2017.

More than three quarters (76.6 percent) of contractors we interviewed nationwide felt the market was either cooling or staying the same, with this figure rising to 77.8 percent in London. By contrast across the three hottest regions - North West England, the South West and the West Midlands - higher levels of optimism drove the proportion of contractors reporting a cooling or static market down to 57.1 percent. Across Britain, 23.4 percent of respondents deemed the market to be heating up - a slight uptick on the 20.9 percent who had felt positive about the market in the preceding three months.

Figure 1:
Turner & Townsend contractor survey Q4 2017

Is the construction market getting warmer, cooler or staying the same?



Modest though it was, this slight improvement in sentiment is likely to have been driven by two factors; the raft of stimulus measures for housebuilders announced in the Chancellor's Autumn Statement and the 'mini breakthrough' in Brexit negotiations achieved in December – which propelled sterling to new highs and spurred hopes that an orderly Brexit will be achieved.

Nevertheless confidence remains in short supply, with the proportion of contractors reporting a heating market now barely a third of what it was two years previously.

London has been hit hardest, with construction output in the capital falling and contractors reporting consistently weak sentiment.

By contrast, a number of regional hotspots are significantly outperforming the capital, and new analysis by Turner & Townsend has revealed that those that are doing best are those with a high degree of devolved power.

This edition of our UK market intelligence will explore the link between devolution and resilience in the current market – and ask whether devolution is providing a regional firewall against the slowdown.

Figure 2:
Turner & Townsend tender price index annual percentage changes

	Building	Infrastructure
2017	2.9%	3.5%
2018	1.8%	4.0%
2019	2.6%	3.8%
2020	3.3%	3.9%
2021	3.6%	4.0%
2022	4.0%	4.5%

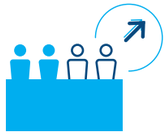
The data shown above is representative for the UK as a whole and costs may vary substantially between regions. For further assistance on cost assurance and inflation analysis in your area, please contact Turner and Townsend

Economic data

GDP (at market prices) index
Q4 2017: 104.4
Q3 2017: 104.0
Increase: +0.4%

Bank of England base rate
March 2018: 0.50%
Dec 2017: 0.50%
No change

Consumer price inflation
Feb 2018: 104.9
Feb 2017: 102.1
Increase: +2.7%



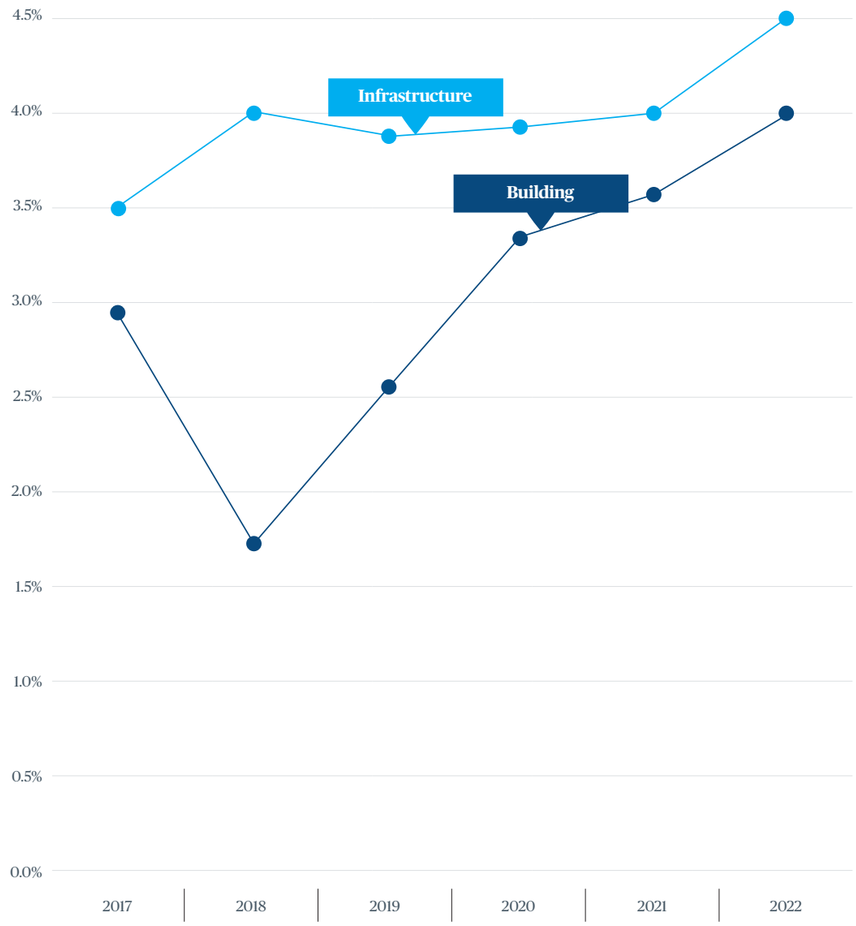
Unemployment level (thousand)
Q4 2017: 1,470
Q3 2017: 1,425
Increase: +3.2%

Construction output index
Q4 2017: 109.9
Q3 2017: 110.0
Decrease: -0.1%

Construction by numbers

Figure 3:
Turner & Townsend tender price index

Annual percentage change



Key indicators

Materials: despite a steady improvement in the value of sterling, increasing material costs are causing upward pressure on price inflation.

Labour: capacity constraints, whilst mildly alleviating, still bite across the industry. Labour costs have steadily risen across 2017 and are expected to follow the same path in 2018.

Overheads and profits: downward pressures on margins persist, resulting in OH&P levels showing subtle decreases.

Preliminaries: limited changes to preliminaries are evident nationally, remaining close to historical levels.

Construction by numbers

In the fourth quarter of 2017 construction employment decreased by 1.6 percent on the quarter and increased by 0.6 percent on the year.

Vacancy statistics were unchanged on the quarter and decreased by 3.3 percent on the year, as of the fourth quarter of 2017.

New orders decreased by 25.0 percent on the quarter and 1.3 percent on the year. The 25.0 percent quarterly loss is the largest since Q4 1987.

Total new company insolvencies in construction decreased by 0.2 percent on the quarter in the third quarter of 2017. However, new company insolvencies increased on the year, by 2.3 percent.

Hot rates

Concrete reinforcing bars index
Q4 2017: 102.2
Q3 2017: 96.1
Increase: +6.4%

Fuel (Diesel) price
Q4 2017: 122.2
Q3 2017: 117.8
Increase: +3.8%

Imported plywood price index
Q4 2017: 112.8
Q3 2017: 107.6
Increase: +4.8%

Structural steel price index
Q4 2017: 102.1
Q3 2017: 98.0
Increase: +4.1%

Copper price index
Q4 2017: 118.8
Q3 2017: 114.4
Increase: +3.8%

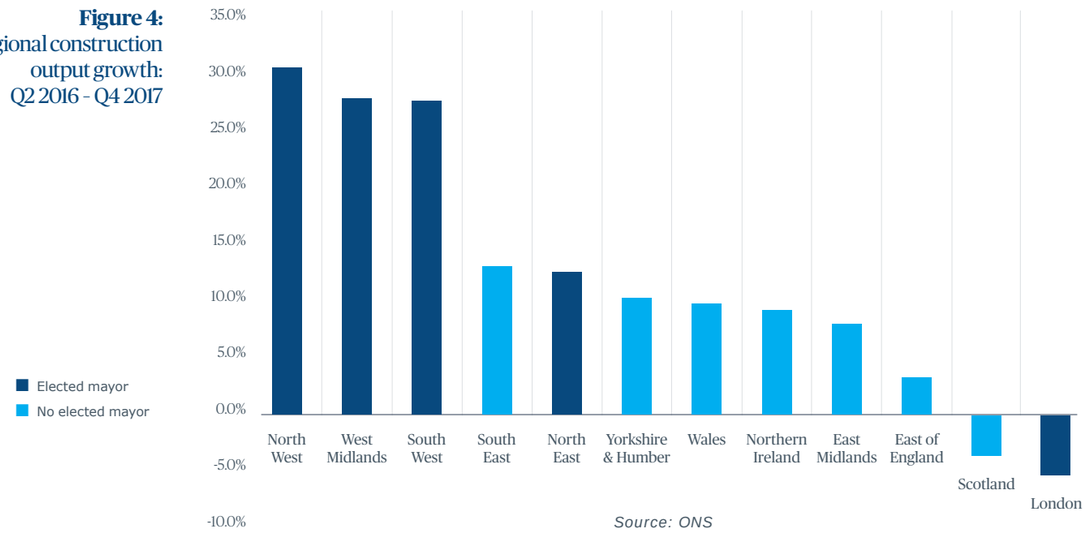
Is devolution providing a firewall against the slowdown?

Few industries are more reliant on - or better indicators of - business sentiment than construction.

As the Chancellor pointed out in his 'Tiggerish' Spring Statement, many of Britain's economic fundamentals remain robust.

But with another twelve months of tough negotiations to go until Brexit finally becomes a reality, the lack of certainty over Britain's future course is weighing heavily on the construction industry. However the weight is being shared unequally across the country. London is suffering most; from the period immediately before the 2016 Brexit Referendum to the end of 2017, output in the capital fell by 5.7 percent.

Figure 4: Regional construction output growth: Q2 2016 - Q4 2017



Source: ONS

By contrast, during the same period output increased by 30.7 percent in North West England, by 27.8 percent in the West Midlands and 27.2 percent in the South West.

All of these are regions with a high degree of devolution, including directly elected mayors and significant regional decision-making powers; and there are early signs of a correlation between regional autonomy and resilience to the confidence-sapping impact of Brexit uncertainty.

Of course London has both a directly elected mayor and a high degree of regional autonomy. But any protection these may have offered to investor sentiment has been overwhelmed by concerns over the capital's heavy reliance on financial services.

ONS data shows commercial new orders in London have fallen by 22.2 percent since the EU referendum, with developer demand pegged back by fears that some of the City's biggest names could be forced to relocate to continental Europe in order to maintain their passporting rights post-Brexit.

Nevertheless housebuilders continue to provide some consistently bright spots in the capital. New private housing output rose by 10.3% between Q2 2016 and the end of 2017, helping stabilise the residential market.

Meanwhile the £3.7bn of new infrastructure orders placed in the third quarter of 2017 have injected some much-needed momentum into London's order pipeline.

That momentum is being sustained into 2018-19, with three flagship infrastructure projects – the Thames Tideway Tunnel, Heathrow Q6 and Crossrail – together committing to more than £1.7bn of capital expenditure this year.

At the other end of the scale, contractor order books in the West Midlands are 92.9 percent full for the current financial year, 12.4 percent above the national average. The region's buoyant market is being stoked by a raft of HS2 infrastructure projects, strong manufacturing sector demand from Jaguar Land Rover and brisk levels of activity in commercial sector construction.

Devolution is playing a key role in driving that momentum. Last November the West Midlands Combined Authority signed a second devolution deal, securing £6 million of central government funds for a housing delivery taskforce, £5 million for a construction skills training scheme and £250 million from the Transforming Cities fund to be spent on local intra-city transport priorities.

The resilience of the regions when compared to London cannot be attributed solely to their lesser exposure to financial services. The North West also boasts a large cluster of financial and related professional services firms; in fact the industry accounts for 7.3 percent of the regional economy and employs some 215,000 people.

In addition to their solid rate of output growth and strong order books, these regions are also showing the classic signs of hot markets – in which high demand and insufficient contractor supply drive up tender prices.

From the period immediately before the Brexit referendum to the end of 2017, tender prices rose by 4.8 percent in the North West and 4.6 percent in the West Midlands and South West England.

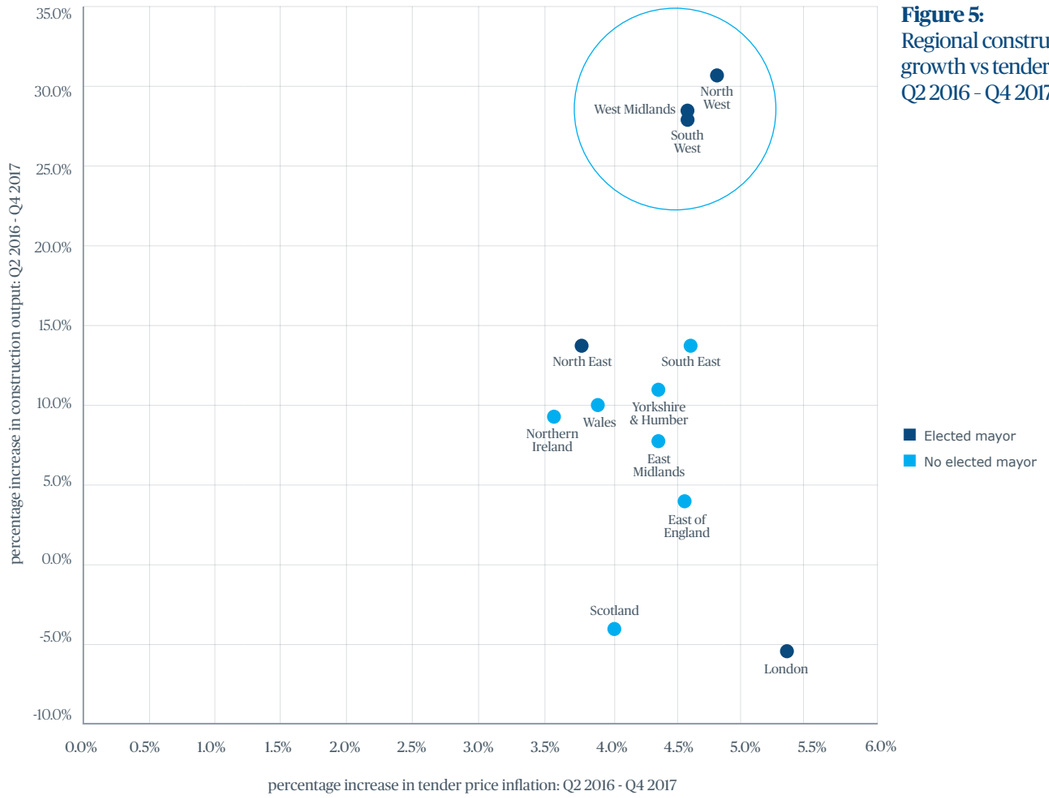


Figure 5: Regional construction output growth vs tender price inflation: Q2 2016 - Q4 2017

Source: ONS and Turner & Townsend

Tender prices in London rose even faster at 5.3 percent, but this was driven instead by a combination of inflationary momentum that carried over from the pre-referendum boom and increasing labour costs.

With London's construction industry heavily reliant on skilled workers from other European countries, the steady fall in net migration from the EU since the Brexit vote has exacerbated the skills shortage and forced up wages.

While the devolved authorities in the best-performing regions can take much of the credit for their continued momentum, they are not the only factor mitigating Brexit uncertainty. More study is required before a definitive link between devolution and market resilience can be proven.

Two become one

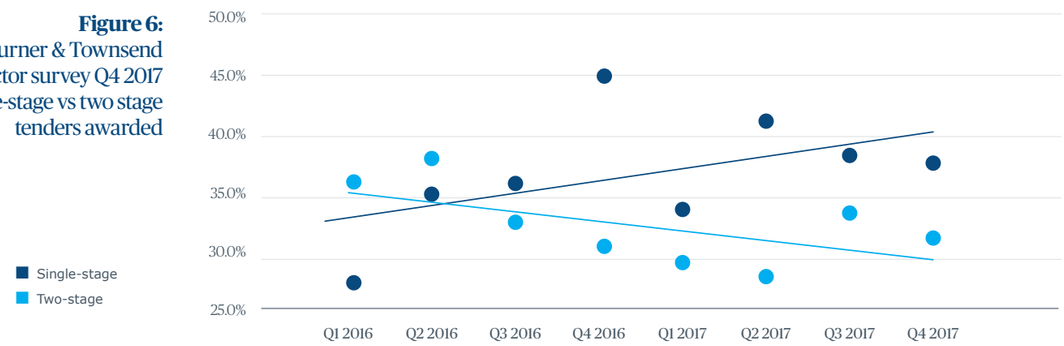
While there remain wide regional variations in construction output, one more universal theme is the steady change in tender behaviour.

Across the UK and Northern Ireland, the past two years have seen a sustained shift from two-stage to single-stage tendering.

In the first quarter of 2016, 27.4 percent of UK projects were offered on a single-stage basis, compared to 36.5 percent on a two-stage basis.

By the end of 2017, that split had changed, with single-stage increasing by 10.7 percentage points, and two-stage falling by 5.1 percentage points.

Figure 6: Turner & Townsend contractor survey Q4 2017 Single-stage vs two stage tenders awarded



Source: Turner & Townsend

Such a swing towards single stage is a sign of a greater urgency amongst contractors to secure turnover in a UK market where order books are more difficult to fill.

Single-stage tenders are often seen as favouring clients, as they increase the intensity of bid preparation work that contractors need to do when pitching, while also increasing the project risk placed on contractors once a price has been agreed.

In colder markets, where the number and appetite of clients is lower, contractors who become concerned about the strength of their pipelines are likely to be willing to jump through additional hoops when pitching – and to accept greater project risk – in order to win orders.

That's certainly the case in London, where 39.9 percent of projects awarded in the final quarter of 2017 were single-stage tenders.

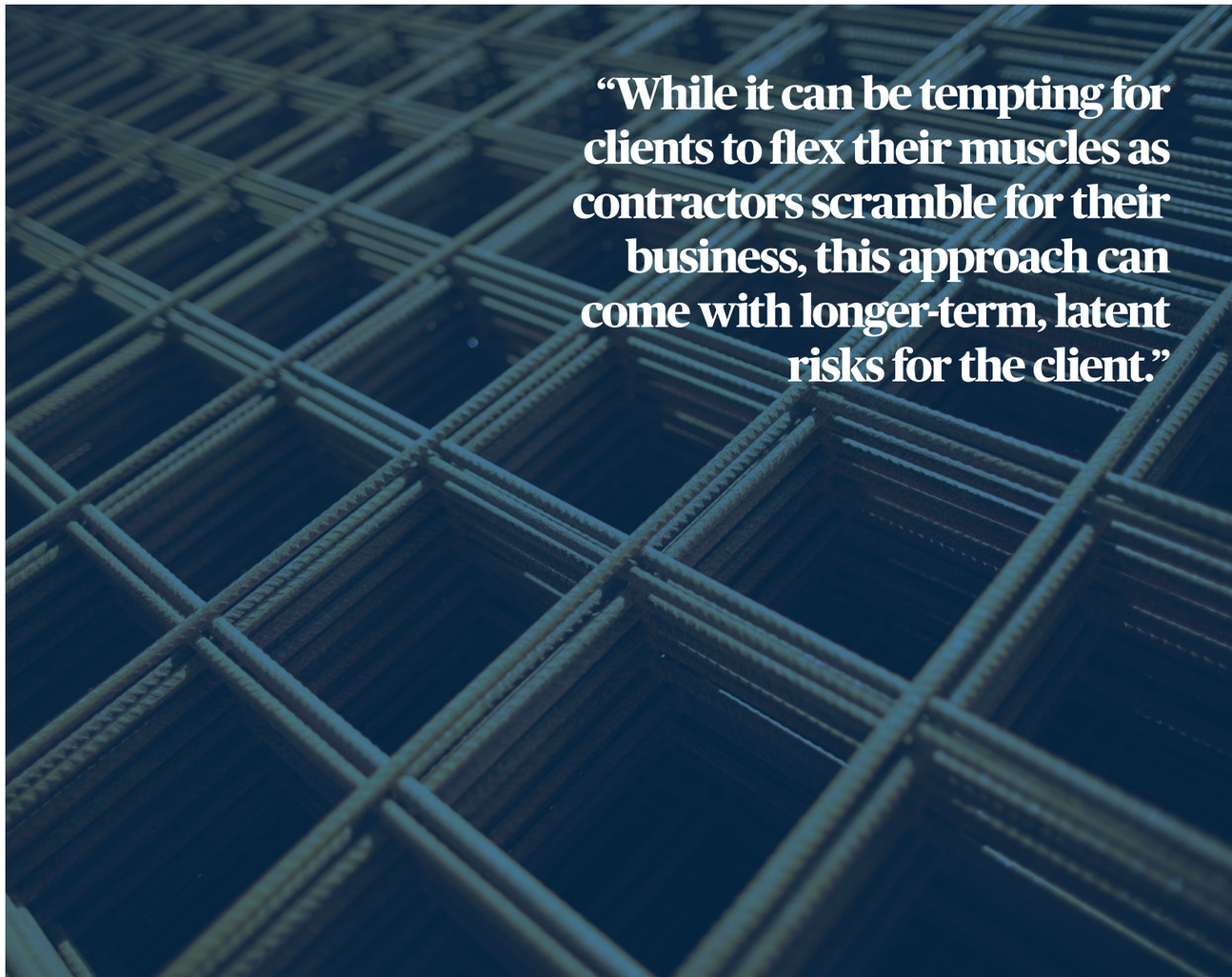
A buyer's market - but buyers beware

Clients should beware of viewing the current 'buyer's market' as a pretext for demanding single-stage tendering in all cases.

While it can be tempting for clients to flex their muscles as contractors scramble for their business, this approach can come with longer-term, latent risks for the client. When the obituary of Carillion is finally written, its authors are likely to identify the seeds of destruction not just in the giant contractor's habit of bidding dangerously low for work in an effort to undercut its rivals, but also in its willingness to take on excessive project risk.

One of the immediate causes of its demise was the £375m it had to write down due to delays on just three PPP contracts in the UK. In the wake of Carillion's collapse, two of those projects – the Royal Liverpool University Hospital and the Midland Metropolitan Hospital – remain unfinished, with completion delayed by at least a year.

While Carillion's vast scale made it a special case, it is far from the only contractor to be pushed to the edge by the current climate. Government statistics show that 2,633 construction companies in England and Wales became insolvent in the 12 months to September 2017, giving construction the dubious honour of the second highest insolvency rate of any industrial sector.



"While it can be tempting for clients to flex their muscles as contractors scramble for their business, this approach can come with longer-term, latent risks for the client."

Delicate balancing act for clients

Clients need to be alert to any signs of contractor distress.

There is a delicate balancing act to be achieved between clients and contractors. The most astute clients will monitor, support and collaborate with their suppliers in equal measure.

In practical terms, this means re-running credit checks and challenging suppliers on their ability to continue delivering, while also seeking to understand and allay their concerns.

Simple questioning of the supply chain will not be sufficient, and success will require an empirical analysis of each supplier's earned value, and expertise in the management of the whole supply chain – right down to Tier 3 suppliers.

The aim should be to establish the financial robustness of the supply chain while also strengthening relationships within it.

In other words, clients should work collaboratively with their supply chain, putting an arm around their contractors while at the same time keeping their eyes open for any sign of weakness. Looking ahead, the need for clients to tender intelligently and work collaboratively is set to grow, as contractors in many regions face a perfect storm of weak demand and compressed margins.

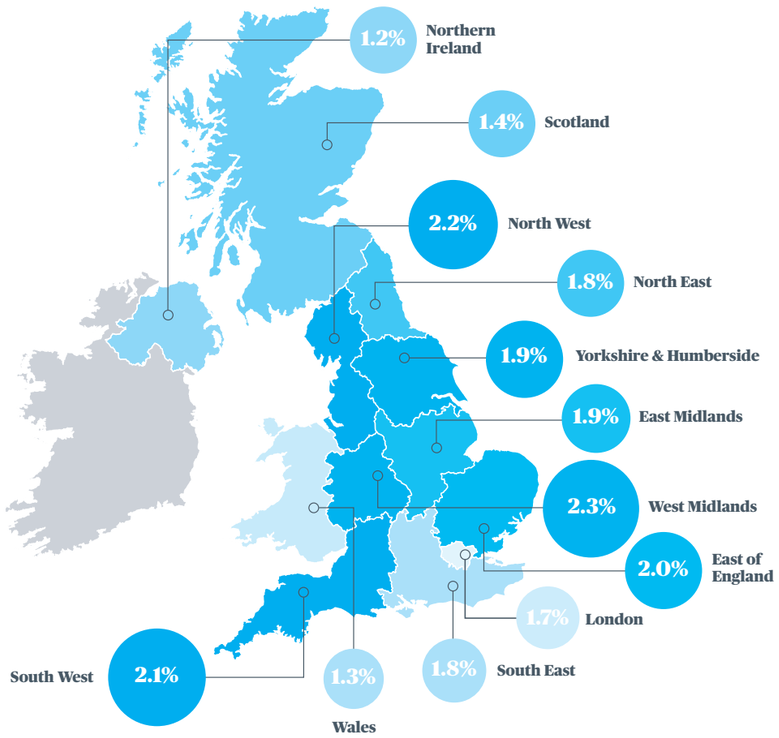
Turner & Townsend's latest regional inflation forecasts suggest tender prices will rise only slowly across much of the UK in 2018.

London, which saw the country's fastest tender price rises in recent years, is expected to see an easing of inflationary pressure – with average tender prices in the capital forecast to rise by 1.7 percent in 2018.

Nevertheless the size and diversity of the London market mean it will see substantial variation across sectors. Residential construction in the capital remains buoyant, with strong client demand and labour shortages firing rising tender prices, while public sector demand has cooled.

Even in the UK's hottest regional markets, tender price inflation expectations are relatively subdued – with increases of 2.3, 2.2 and 2.1 percent anticipated in the West Midlands, North West and South West respectively.

Figure 7: Turner & Townsend regional tender price inflation expectations 2018



Labour cost threats lurk over the horizon

The prospect of such modest increases in tender prices is likely to keep the pressure on a supply chain that's already seeing its margins squeezed by systemic skills shortages and high material cost inflation.

This challenge will be at its most acute in London, where contractors risk being caught in a double bind of sharply rising labour costs and weaker demand that gives less scope for tender price inflation.

As of Q3 2017, nearly half – 44.5 percent – of the capital's construction workers were born outside the UK, according to the ONS labour force survey. Such heavy reliance on imported skills would be a huge liability if Brexit were to trigger an exodus of foreign workers.

While the UK and EU agreed in March that the current free movement of EU citizens would be allowed to continue into the post-2019 Brexit transition period, Britain's divorce from the European bloc is nevertheless likely to interrupt the flow of EU workers to the UK. ONS data suggests this is already happening, with net migration from the EU falling by 75,000 in the year to September 2017.

With the unemployment rate in the construction sector as a whole sitting at a historic low of 1.9 percent, the industry is effectively at full employment and London's contractors could face intolerably high wage pressure without access to a ready supply of foreign nationals.

Despite the London market's modest price expectations for 2018, serious inflationary threats lurk over the horizon in 2019 and beyond.

Seen in this context, the use of single-stage tenders becomes more problematic. Though they may initially appeal to clients because of their ability to transfer project risk to the supply chain, their long-term wisdom is open to question if they impose excess levels of stress on weaker suppliers.

In other words, despite their outward attractiveness, just because clients can ask for single-stage tenders doesn't always mean they should.

Far better to tender intelligently, ensuring risk is distributed equitably between client and supply chain, and then follow up with a collaborative working relationship built on robust project controls that will serve as both a guarantor of efficiency and an early warning system.

About Turner & Townsend

We are an independent professional services company specialising in programme management, project management, cost and commercial management and advisory across the real estate, infrastructure and natural resources sectors.

With 104 offices in 44 countries, we draw on our extensive global and industry experience to manage risk while maximising value and performance during the construction and operation of our clients' assets.

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