The end of the beginning

UK Construction
Market View

Winter 2021

Introduction

Multiple lockdowns make the road to recovery bumpy. Recovery may feel a long way off but with an expanded government investment programme, a Brexit deal and a rapid vaccine rollout, prospects are much brighter in early 2021.

- The UK and the EU signed a post-Brexit trade deal on the 24th of December 2020, granting us all an early Christmas present after months of intense negotiations. The unsettling uncertainty that has held back the UK and its potential investors for the last few years is finally gone. The deal helps avoid the major disruptions that could be caused by the introduction of tariffs and quotas, but companies will still need to adapt to new rules and navigate through new administrative requirements.
- While uncertainty related to the post Brexit relationship with the EU has been removed (although its exact nature is yet to be seen in practice), for most companies and investors, the impact of the pandemic remains the top challenge. The approval of vaccinations resulted in a surge of optimism, as reflected by a net increase of 58% of CFOs being more upbeat about their financial prospects in Q4 2020 (Deloitte CFO Survey). While the discovery of a new virus strain has placed unprecedented pressure on the NHS and triggered a third national lockdown, the simultaneous roll-out of the immunisation programme has enabled businesses to maintain an optimistic outlook based on the foreseeable easing of restrictions.

- Latest ONS data indicates that GDP decreased by 2.6% in November (during the second national lockdown), leaving still a gap of 8.5% to pre-COVID levels. The effect of the temporary easing of restrictions before Christmas, followed by the third lockdown will be reflected in GDP fluctuations in the short-term. However, assuming the successful roll-out of the vaccine, we are likely to see more stable growth from Q2-Q3 2021. According to the Bank of England, if restrictions on movement and activity lessen in Q1 2021, full recovery to previous levels of output should be achieved by Q1 2022.
- According to the ONS, the unemployment rate at the end of September 2020 was 5%. It is projected to reach 7.75% in Q2 2021, once furlough measures are removed. Numbers employed in the construction sector are 7% lower compared to the same time last year. ONS data shows that the number of EU-born workers has fallen by around 25% in the year to September 2020. However, there is currently no evidence of actual labour shortage. As a positive sign, with 4.5 million applicants to the settlement scheme, the odds are that at least part of the migrant workforce are here to stay. In the long-term, increasing demand will most likely stimulate a recovery in labour costs.
- The latest data from the Builders' Conference indicates that tender opportunities remained relatively scarce in December; 26% lower on a year-on-year basis. Also, the number of contracts awarded decreased by 23% compared with the same period in 2019. Despite these grim reports, construction sector business sentiment remained unchanged from November and, with a PMI of 54.6, is still very much in expansion territory. It is mainly driven by high levels of activity in the housing sector, still benefitting from the Stamp Duty tax holidays, and catch-up work, but there are also new contracts coming through. However, in the medium term and with the new work pipeline still looking weak, there is little room for complacency with respect to future workload.
- The recovery in output that started in the summer has continued throughout the Autumn. In November, monthly output reached pre-COVID levels, driven by the strong performance of infrastructure and repair and maintenance sectors, which increased by 11% and 7% year-on-year respectively. New orders at the end of Q3 recovered to the levels observed at the same time last year, which again is a positive sign. However, even if a similar level of orders could be maintained into Q4 2020, there will still be a workload shortfall of 10% compared with Q1 2020, before COVID-19 struck. This points to a competitive market in the short-term before normal levels of workload return.
- The Winter Forecast by the Construction Products Association (CPA) did not change significantly in terms of anticipated output, however, there have been some modifications relating to the performance of sectors, for example private repair and maintenance has been revised up. Construction is forecast to decrease by -14.3% in 2020, followed by an increase of 14% in 2021 and 4.9% in 2022. As a result, output in 2022 is expected to be 2.6% above 2019 levels, with all sectors but public housing and commercial having recovered to pre-COVID-19 levels. By contrast, activity levels in infrastructure are forecast to have increased by 30% over the same time as a result of increased government spending.
- In the Chancellor's November 2020 Spending Review, the Government's long-term commitment to investment was confirmed with remarkable multi-year spending allocations for infrastructure, schools and hospitals, and continued investment in the housing sector. Given that the rest of the Spending Review was a single year settlement, the scale of the commitment was a real vote of confidence in the sector. These spending allocations support well-established long-term programmes and provide greater certainty to the supply chain. The ability to turn the promises of the pipeline into on-site projects will be pivotal in supporting the construction sector recovery throughout 2021/22.

Forecast

At the worst point of the pandemic, the pathway to recovery is much more certain than before. With a strengthening orders pipeline and real inflation in materials and other inputs, we have upgraded our short-term inflation forecast and have greater confidence in our long-term outlook.

Construction output continued its recovery in the last quarter of 2020. Despite productivity limitations and the introduction of a second national lockdown on the last day of October 2020, by the end of November, pre-COVID levels of activity were achieved. Growth came mainly from infrastructure (10% increase year-on-year), and repairs and maintenance (7% year-on-year growth). Even if that trend was maintained throughout December, there will still be a 12.5% reduction in output compared to 2019. New orders data for Q3 2020 showed a return to pre-pandemic levels, but no surplus work was recorded and, even with orders maintained in Q4, 2020 will leave the sector with a 10% (£4.5 billion) gap. This shortfall in turnover and future workload means that markets will remain competitive. However, conditions are improving, and inflationary pressure is returning.

Short-term pain…

Looking at the situation right now, with the UK in a third lockdown, in the short-term the outlook is negative. GDP fell by 2.6% in November, and a double-dip recession into Q1 2021 is quite possible. However, the construction sector has continued working at much higher volumes than seen in April/May 2020.

When Brexit concluded with a thin deal, many materials merchants and importers were relieved – the risk of sudden cost hikes due to tariffs was avoided. Unfortunately, a more widespread global crisis in the supply of materials and components has emerged (more on this issue in 'Spotlight on'). A combination of critical material shortages and insufficient cargo containers are resulting in significant inflationary pressures. In the short-term, these supply chain constraints will create challenging circumstances for contractors, who are facing input-cost inflation at a time of (still) subdued demand. Yet, as we go on to show, prospects for the construction sector have improved since our last forecast.

…but a long-term gain

The last days of November brought a real injection of confidence in the form of long-term spending commitments in the Spending Review. Not only was the record investment in infrastructure confirmed, but also new funding to support continuous delivery of housing was announced. 2021 also kicked-off with the launch of a £7 billion framework for the Department for Education. How quickly other procurements can progress will determine the extent of a potential new work hiatus. The public sector is leading the way as a major investor, willing to support the sector recovery, but also clearly stating its demands regarding industry transformation. They are set out clearly in the recently published Construction Playbook. The entire supply chain needs to be ready to work with an interventionist client that is determined to see the benefits of improved industry performance.

The administration of vaccines followed shortly after the Spending Review. The successful large-scale rollout of immunisation will ultimately enable the construction sector to overcome productivity limitations imposed by the introduction of the strict

Site Operating Procedures. It also diminishes the odds of another harsh lockdown and increases the likelihood of life going “back to normal”. This is also important for many private clients who will finally be able to verify the viability of their planned investments against the post-pandemic reality. Undoubtedly, some will cancel their projects, others may redefine and redesign, and there will also be a group that will spot new opportunities. None of them, however, will be burdened with “Brexit uncertainty”.
The word “unprecedented” will more and more often be replaced with “clarity” and “certainty”, taking investors out of the state-of- limbo that the pandemic and Brexit imposed.

The Forecast

In our Autumn Forecast, we moved away from the Swoosh-type recovery scenario towards a less optimistic approach, underpinned with slower than anticipated GDP growth and a weak orders pipeline. Back then, there was a strong deflationary climate driven by the pressure to secure short-term workload.

At present, this pressure has faded and hence the deflationary drivers related to demand are weaker. According to the ONS, after a significant dip of almost 10% during 2020, there is growing evidence that wage levels in many parts of the country have returned to pre-COVID levels.

However, the picture is mixed. While in general, the number of vacancies across industries is 30% lower than last year, for construction it is 1.6% higher, indicating that the levels of activity are picking up. Hence, the limited availability of materials described earlier, along with driving inflation, are less likely to be offset by reduced labour costs, even though competition for work remains high. Materials inflation is likely to be a short-term factor, as most of the triggers for shortages are related to COVID-19 recovery. We are reflecting these changes through adjustment to the regional and London building rates in 2021, which we expect to increase marginally for the former and remain flat for the latter.

Our long-term forecast does not change, and we anticipate that the public sector will spearhead recovery, which will be reflected in infrastructure TPIs returning to the long-term trend by 2022. Building TPIs will follow, supported initially by the Government investment and then the gradual return of private sector investment. We expect that with levelling-up high on the priority agenda, regions may see activity recovering quicker than London. Post Q3 2022, the equilibrium will shift towards inflation, as recovered demand will be matched with the usual capacity constraints, especially regarding labour availability.

	Short-term (Q1 2021- Q3 2022)	Long-term (Q3 2022 onwards)
Inflationary factors	• Expansion of activity in social and economic infrastructure	
		• Labour shortages because of post-Brexit points-based migration system
	• Productivity still impaired by COVID-19	
	• Increased costs of logistics for materials imports	
	• Increase in material costs due to shortages	
		• Recovered demand from the private sector
Deflationary factors	• The need to secure short-term workloads	
	• Subdued demand from private sector	
		• Productivity gains due to digitalisation and standardisation
		• Sterling appreciation

	Regional Building Construction TPI	London Building Construction TPI	National Infrastructure Construction TPI
2020	-3% (-3%)	-4% (-4%)	0% (0%)
2021	1% (-1%)	0% (-2%)	2% (2%)
2022	2% (2%)	2% (2%)	4% (3%)
2023	3% (3%)	4% (4%)	5% (5%)
2024	5% (5%)	5% (5%)	5% (5%)
2025	5% (5%)	5% (5%)	5% (5%)
Total	**13%**	**12%**	**21%**

Zoom into: The Construction Playbook

The Construction Playbook will enable the public sector to deliver whole-life value from expanded investment programmes more effectively, while supporting the transformation of the construction industry.

Published in December 2020, the Construction Playbook is part of a wider programme of reforms intended to create the conditions for investment into productivity improvements on infrastructure projects and programmes, known as Project Speed. The Playbook's main objective is underpinned with three cross-cutting themes:

- Health, safety, and well-being (workforce)
- Building safely (quality of product, process and people)
- Building back greener (sustainability and net-zero carbon)

The measures included in the Playbook are mandatory and will be implemented by all Central Government Departments and their arms-length bodies for the next three years, beginning December 2020. Fourteen formulated policies will inform the way projects are assessed, procured and managed, and will be enforced through spending controls. These policies address many of the long-standing pain points of the construction sector.

Low productivity and innovation uptake

The lack of appetite to invest in new technologies and slow pace of innovation is often explained by the lack of visibility of future projects and too-short contracts. A beefed-up central government **procurement pipeline for public works** projects will give long-term visibility of demand, while a shift to **portfolios and longer-term contracting** will create the certainty required to invest in new technologies. Project and programme teams conducting **market health and capability assessments** will be informed about emerging technologies, opportunities, and limitations, and will be able to adjust requirements accordingly.

The implementation of platform approaches, standard products and components will be accelerated through **harmonised, digitised, and rationalised demand.** Widespread use of the UK BIM Framework and standardised approach through Information Management Frameworks are ways to **further embed digital technologies**, harvest the potential of data and enable continuous asset optimisation through creation of the National Digital Twin.

Siloed project functions and inefficient delivery

Lack of cooperation between stakeholders often results in multiple changes further down the delivery line and leads to delays and escalating costs. Therefore, the Playbook advocates **early supply chain involvement** by creating integrated teams including designers, Tier 1, 2 and specialist contractors, as well as asset operators. When providing their input into business case development, they are expected to adopt an **outcome-based approach**, which puts an emphasis on whole life performance.

The collaborative spirit of the initial project stages will be extended into delivery phases through evidence-based selection of the most suitable **delivery model**, as well as an **effective contracting strategy** intended to support an exchange of data, drive collaboration, improve value and manage risk.

Misplaced risks, escalated costs and threat of insolvency

Inappropriately allocated risk, incorrect pricing and faulty payment mechanisms often lead to "quality shortcuts", cost escalations and can even result in contractor's bankruptcy, which impacts both the client and the rest of the supply chain. **Benchmarking and 'should cost'** models use lessons from previous projects to improve investment decisions. Suppliers will be incentivised to deliver agreed outcomes through an adequate **payment mechanism and pricing approach**, and more scrutiny given to **risk allocation** should help to make the public sector a more attractive client.

However, scrutiny will work both ways and suppliers must be ready to undergo an **assessment of their economic and financial standing.** They should also prepare a **resolution plan** to mitigate risks to continuity of critical public works resulting from potential business failure.

The proposed interventions will have a direct impact on ways of working for everyone involved in projects or programmes, including the client, design teams, as well as multiple contractor tiers, including specialist contractors. The key messages for the supply chain are:

1. You need to be proactive in implementing the playbook, ensuring that both your own organisation and your sub-contractors are ready to act on the Government's recommendations. There is an increased focus on participation from SMEs, especially ones pioneering new technologies. The nature of relationships between stakeholders needs to continue shifting, moving from highly transactional towards a Project 13 enterprise-like relationship, in which both risks and rewards are shared.
2. Establish a manufacturing mindset. To generate anticipated benefits, implementation of modern methods of construction (MMC) needs to be accompanied with the adoption of a manufacturing mindset – that is, an approach that uses the data on a regular basis to monitor, optimise and continuously improve the process, targeting both efficiency and quality. The Construction Innovation Hub's work on the Construction Quality Planning Guide, referenced in the Playbook, will provide further insight.
3. (Re)consider your business model. Adopting an outcome-based approach to projects involves a shift from cost-based to value-based procurement. Contractor-led teams will need to understand the value that is sought and work closely with the client on the best (not the cheapest) way to deliver it. New commercial models, such as alliances, are likely to emerge. For example, Anglian Water has created an alliance, in which contractors became shareholders, incentivised to outperform the baseline through the application of innovative solutions.

In the initial months of the pandemic, much was said about the unprecedented efforts that both clients and supply chains put into enabling the continuity of construction work. Now, with the approval of vaccines, we finally see the beginning of a long and bumpy recovery road. The Construction Playbook is a slow-release jab meant to help retain the collaborative spirit that emerged in the first days of the crisis, until it becomes embedded for good.

Spotlight on: Construction materials – short term pain?

An unexpected side-effect of the COVID-19 pandemic is starting to affect UK construction markets – a world-wide shortage of materials.

Whilst global activity levels are down compared to 12 months ago, many aspects of the materials supply chain, manufacture, transportation, and logistics are coming under pressure. Not only are prices likely to increase but, more significantly in the short-term, it may become difficult to source key materials. Early 2021 is set to be a bumpy ride – even as construction firms plot a route to recovery.

A complex global issue

Materials availability was a major problem at the peak of the first wave of the virus in May/June 2020, when UK-based manufacturing closed-down in response to a drastic fall in demand, resulting in a sudden drop in supply of key materials, such as plasterboard. The current problems, however, are tied to the global recovery from COVID-19, and as a result will be more difficult to resolve in the short term. Recent news of UK car manufacturing plants being shut down due to a shortage of semiconductors illustrates the extent of disruption to global supply chains.

Raw materials and products that are being affected by shortages include timber and structural steel, as well as small components imported from Asia. A review of the causes of these shortages highlights just how complex the issues are. However supply constraints are not universal. Some manufacturers have built stockpiles, and locally manufactured products are mostly not affected.

Causes and impacts of material shortages

Material	Cause of disruption	Impacts
Carcassing timber	• Shortfalls in UK timber imports during H1 2020 • Significant increase in global demand in H2 2020, particularly in the US • Loss of European sawmill production due to COVID-19 • Reduced volume of European felling during 2019/2020 due to poor weather conditions and pest control activity	• Timber products being made available on allocation • Price increases of at least 8% (BEIS)
Structural steel and galvanised steel strip products	• Reduced global steel production in H1 2020 • Reduced levels of steel imports into the UK in H2 2020 • Increased global demand	• Extended lead-in periods for steel sections • Price rises of £210 on basic sections declared in the past 12 months (Current 15 Jan 2021)
Electrical products (switchgear, cable terminations, cable tray)	• Manufacturing constrained by the availability of critical materials – e.g. specific steel grades	• Impacts currently unknown
Fixings, components, and small tools (products imported from Asia using global logistics networks)	Shipping constraints including: • Increased volumes of global container traffic • Congestion at UK ports resulting from COVID-19 and Brexit stockpiling • Shortages of empty containers in Asia	• Lack of availability of components in the UK supply chain – potentially affecting manufacture or completion of works on site • Premium costs associated with accelerated transport – e.g. air freight
Shipping costs generally	• Shipping constraints as above	• Container freight rates have increased by 270% since January 2020

Anticipated project impacts

These developments can be expected to filter into project costs during the first half of 2021. Existing projects will potentially be more vulnerable, as material shortages might result in the need to reschedule works in line with product availability. Furthermore, as recovery accelerates, additional categories of products may become exposed to material shortages. Our assessment is included in the forecast section.

Looking at projects in procurement, the critical question is whether the price increases are temporary or permanent, and how long the disruption might last.

Our view is that the current burst of inflation is temporary, for the following reasons:

- Overall global trend is for low inflation related to slow growth and excess capacity
- Material shortages have been caused by one-off COVID-19 related factors – e.g. production shut-downs, crew shortages and container traffic disruption
- Demand has been triggered by one-off events – e.g. the UK's current repair, maintenance and improvement (RMI) boom.

Some high-demand, sensitive markets such as container traffic could continue to see price inflation but will return to normality as quickly as the market has rebalanced itself – for example, once there are sufficient containers in Asia to enable a smooth turnaround of goods. However, for sectors such as structural steel, where price inflation has been quite suppressed in recent years, it may prove harder to bring costs down to previous levels.

Material price inflation has not been a significant problem for the UK construction industry since before the financial crisis in 2008. The current episode is more likely to be a blip than the start of a trend. However, it is a useful reminder that resilient supply chains are essential for the reliable delivery of capital projects.

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