ARCADIS Design & Consultancy for natural and built assets

UK CONSTRUCTION MARKET VIEW

On a Cliff Edge

SUMMER 2019

Introduction

- Since our last forecast, business sentiment has decreased further. This is evidenced by the August Manufacturing PMI (47.4) and Construction PMI (45.0), which both recorded weakening sentiment and indicate declining prospects. Additionally, recent disappointing ONS New Orders data for the 2nd quarter reveals a 5% year on year decrease in the industry order book.

- The arrival of Boris Johnson at No10 has not broken the Brexit log-jam, with a possible third extension to Article 50 coming back into play. For construction markets, this could mean further delays to clients' decisions and continuing uncertainty regarding future workload.

- On a more positive note, after a 0.2% contraction of the UK economy in Q2, a growth of 0.3% has been reported in July. This coincided with the release of the UK Services PMI, which, at 50.6, was slightly lower than in July, albeit still in the "stable range". It appears that despite weakened business optimism, the UK economy maintains resilience.

- The cliff-edge character of the UK economy is well-illustrated by the fortunes of construction. Output in the first seven months of the year was up by 2% in real terms – more than seen in the whole of 2018. This makes it particularly difficult for construction businesses to serve their existing pipeline whilst facing the risks of a declining backlog.

- Overall, construction output is expected to fall by 0.3% in 2019, driven by a weak commercial sector, before picking up 1.0% in 2020 and 1.4% in 2021 (CPA).

- Early signs of a global economic slowdown and persisting uncertainty, fuelled for example by further escalations in trade wars, the protests in Hong Kong, and continuing tensions in the Gulf, are likely to slow the growth of Foreign Direct Investment, albeit the UK retains its status as the leading destination for tech investment in Europe.

- With most Central Banks, including the Bank of England, likely to follow the lead of the US Fed in cutting interest rates, coordinated monetary stimulus will be used to support domestic demand in the face of the deteriorating economic outlook. The ECB is also calling on governments to use fiscal measures to boost European economies.

- Delays to Brexit and the increasing likelihood of a UK election continue to shift the attention away from the long-term horizon. September's Spending Review announced a £13.4 billion boost in spending but postponed announcements on long-term capital spending commitments. This delay, combined with the review of HS2, further delayed the point at which UK industry will have clarity on its public sector pipeline.

Drivers behind Tender Price Forecast

We have maintained our forecast at the levels presented in the Spring 2019 Market View. There are numerous factors, both inflationary and deflationary, that play a role. Our logic in applying them is described below.

The forecast continues to be based on the assumption that a Brexit deal is secured and the UK will enter a period of transition at the end of 2019. This assumption remains the base case adopted by economic forecasters. We examine alternative scenarios based on a no-deal outcome later in this paper.

Materials – The inflationary trend that started after the referendum continues, with the latest data indicating cost growth of 3%. Should Brexit disruption occur, prices are likely to increase further as a result of currency fluctuation and limited availability. Energy price decreases are likely to be muted, while commodities prices are slowly picking up, metals especially.

Labour – The total net migration from EU2 and EU8 is still positive, at 25,000 per annum, however it has decreased by approximately 50% since September 2016. The positive net migration figure is driven mainly by continuing migration from EU2 countries. Any resulting resource constraints will drive up the cost of labour. Companies that directly employ their labour and which actively promote settled status to their EU workforce will be in a better position to minimise these impacts.

New infrastructure frameworks – A number of control periods and project frameworks are starting in sectors including rail, water or highways. The procurement of new contracts will potentially provide bidders with an opportunity to recalibrate their prices – not only for background cost inflation, but also for other commercial considerations including improved margins as well as the “Brexit effect”.

(Temporarily) subdued demand – The delay triggered by the extension to Article 50 from March to October has resulted in prolonged uncertainty and the suspension of investment decisions. This has resulted in the deterioration of levels of workload and business confidence, as evidenced in the latest PMI Indices and ONS New Orders data. A positive Brexit resolution is expected to trigger a recovery and increasing demand in what is a very competitive market. The level of recovery is, however, likely to be muted by the global economic slowdown.

Workload security – The uncertainty around Brexit has resulted in delays to projects secured, as well as to those being brought to market. We can see that contractors have responded in different ways. Some state clearly that temporary downsizing is the preferred option and they will not pursue low-margin work in pursuit of turnover. Others are willing to consider making their proposals more competitive. The balance of these two opposing forces will be very influential in determining market conditions over the coming months.

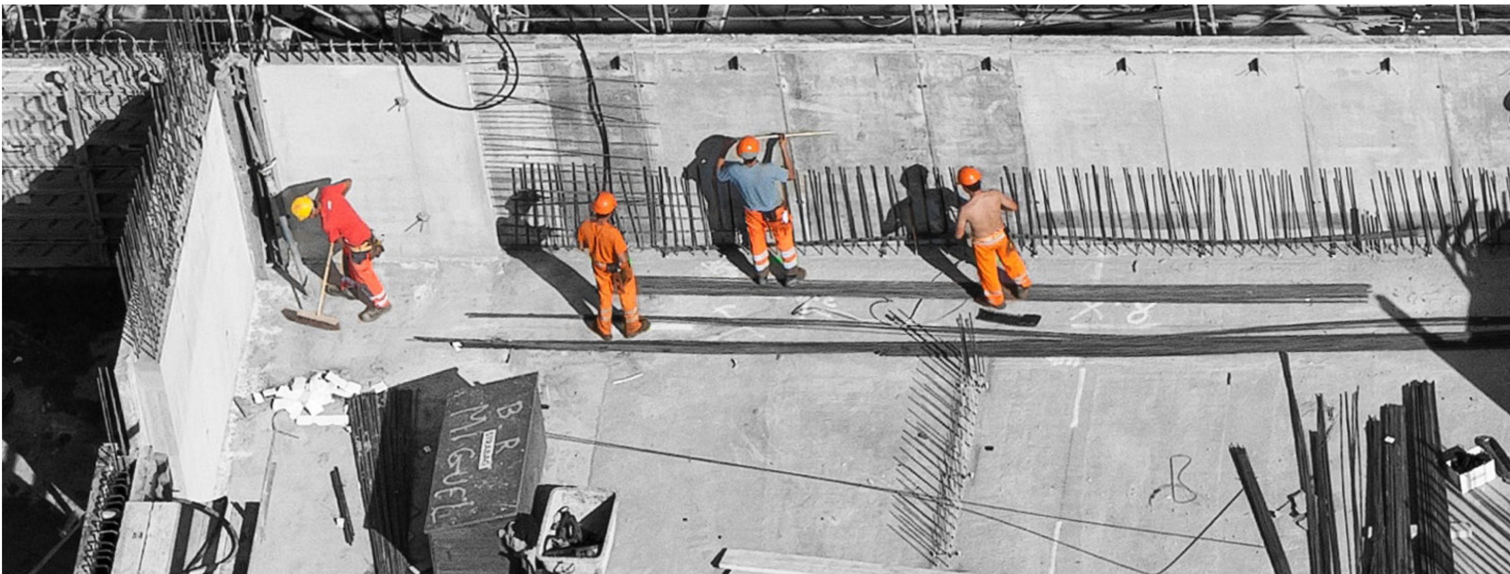
Appetite for risk – Tier one contractors continue to highlight their focus on big, complex projects. We also see more and more mid-sized contractors displaying an increased risk appetite, taking on projects they would previously have considered too risky. This may increase the number of options that clients can choose from, influencing their negotiation position, albeit clients may feel that the commercial risks associated with these contractors may be a step too far in the current market.

The continuation of Brexit uncertainty coinciding with a deteriorating pipeline of work is creating challenging conditions both for contractors and clients. The former are trying to maintain their commercial position, which leads to increases in prices. As a result, the latter are more likely to accept a greater risk transfer through package-based procurement. The viability of investment programmes will depend on specific steps, which clients will only be able to identify after it becomes clear if contractors have managed to maintain their position for the next six months.

Our Tender Price Forecast

Our forecast is based on the following assumptions:

- Managed exit from the EU with a period of transition prior to the agreement of a long-term political and economic relationship.
- UK GDP growth @ 1.0% (2019) and 1.4% (2020) (BoE forecasts)
- UK CPI @ 1.7% (2019) and 1.9% (2020) (BoE forecasts)
- UK Base Rate @ 0.5% by Q4 2020 (BoE forecast)
- £1 = €1.12 and £1 = $1.25 by Q4 2019
- New build construction output falling by 0.3% (2019) and increasing by 1.0% (2020) and 1.4% in 2021 (CPA)
- Construction workforce remains at 2.2 million



% movement in the year to Q4.

Bracketed %s are last quarter's forecast.

YEAR	REGIONAL BUILDING CONSTRUCTION TPI	LONDON BUILDING CONSTRUCTION TPI	NATIONAL INFRASTRUCTURE CONSTRUCTION TPI
2018	2% (2%)	2% (2%)	3% (3%)
2019	3% (3%)	2% (2%)	4% (4%)
2020	3% (3%)	3% (3%)	4% (4%)
2021	3% (3%)	3% (3%)	4% (4%)
2022	4% (4%)	4% (4%)	5% (5%)
2023	4% (4%)	4% (4%)	5% (5%)

Potential implications of "no-deal" Brexit and/or a further extension

The arrival of Boris Johnson at No10, accompanied by his promise of Brexit delivery by 31st October 2019, has significantly increased the likelihood of a disruptive no-deal outcome. While no official forecast has been published, should no-deal occur, widely used scenarios point to an economic contraction in 2020 which will include a fall in asset prices. In preparation for such an outcome, we have revisited our 5-point plan of preparation for Brexit, published in the Winter 2019 edition of Market View.

The 5-point plan places a particular emphasis on the supply chain's ability to secure labour and material resources. Clients that have followed the plan will have much improved visibility with respect to the ability of their supply chain to secure the resources needed to deliver their project.

Other areas that could be affected by the wider implications of a no-deal include:

Timing of procurement events. Recent fluctuations in the value of sterling have highlighted the impact of Brexit negotiations on commercial dealings. In addition to heightened risk around potential exit dates in October, December or January 2020, other events that could affect the value of Sterling include the party conferences, the Queen's Speech and a forthcoming general election.

Suspended public-sector procurement. Departure from the EU without a deal is likely to cause a more profound disruption to the operation of Government as it acts to mitigate some of the most severe consequences that have been highlighted by planning for Operation Yellowhammer. We foresee that short-term re-prioritisation could delay spending plans and approvals for the initiation of major schemes. Public sector new orders fell by over 25% in the second quarter of 2019 – is this a portent of things to come?

The UK's attractiveness to overseas labour. Recently announced and hastily aborted plans to end free movement of labour, combined with the further depreciation of sterling are likely to have further reduced the attraction of the UK to both the current and future overseas workforce.

Irrespective of outcome, the extension to Article 50 until 31st January 2020 is not helpful to industry prospects. Key areas where we have concern include:

- Ongoing lack of clarity is likely to put companies into a further state of limbo – for example abandoning Brexit preparations triggered by the increased probability of a no-deal.
- The extension of the negotiation period is likely to decrease business confidence and further delay investment decision-making.
- Timing of the extension. Extending Article 50 to Christmas, which will coincide with many EU operatives' holidays, may act as a further encouragement for some migrant workers to look for work elsewhere in the EU.

Steps to restore business confidence

Many forecasters have anticipated a post-Brexit boost in the event of an agreement. However, with the increasing likelihood of a disruptive Brexit, we have been looking at what steps might be taken to boost the UK economy as it comes out of the EU.

Unfortunately, Brexit is likely to coincide with a wider economic slowdown, triggered partly by US-China trade wars, but also by protests in places like Hong Kong that have broader social and economic consequences. All these events are contributing to a fall in business and consumer confidence, highlighted by a number of recent disappointing surveys.

This deeper malaise means that kick-starting a recovery will need more than interest rate cuts. It will depend on the concerted effort of everyone involved – government, regulators, financial sector, private sector and consumers alike. In this section we briefly describe widely-trailed policy measures that the current UK government could use to encourage GDP growth and the return of long-term investment – from businesses and consumers. Some of the actions can be easily implemented, while others may require some time before they could come into play. The big question is whether these actions will encourage activity in the construction sector, and to what extent they will prop other parts of the economy?

Boosting consumer spending. Universal tax incentives such as lowering of VAT or more nuanced interventions like an increase to tax allowances focus on an increase in consumer spending. By putting money directly in consumers' pockets, this measure could potentially trigger investment in, for example, housing or consumer goods.

Incentives for capital investment. Capital investment has flat-lined since the 2016 referendum, so any short-term changes to the corporate tax system are likely to focus on stimulating investment in productivity.

This could be achieved by increasing the annual investment allowance (AIA) or by adjusting the rules for capital allowances for plant and machinery.

Creation of economic zones and freeports. Special economic zones have been widely promoted and could facilitate the inflow and outflow of goods between the UK and other trading partners, including the EU. Economic zones could benefit from a range of incentives designed to attract Foreign Direct Investment (FDI) as well as domestic demand. These areas could see significant investment in logistics infrastructure.

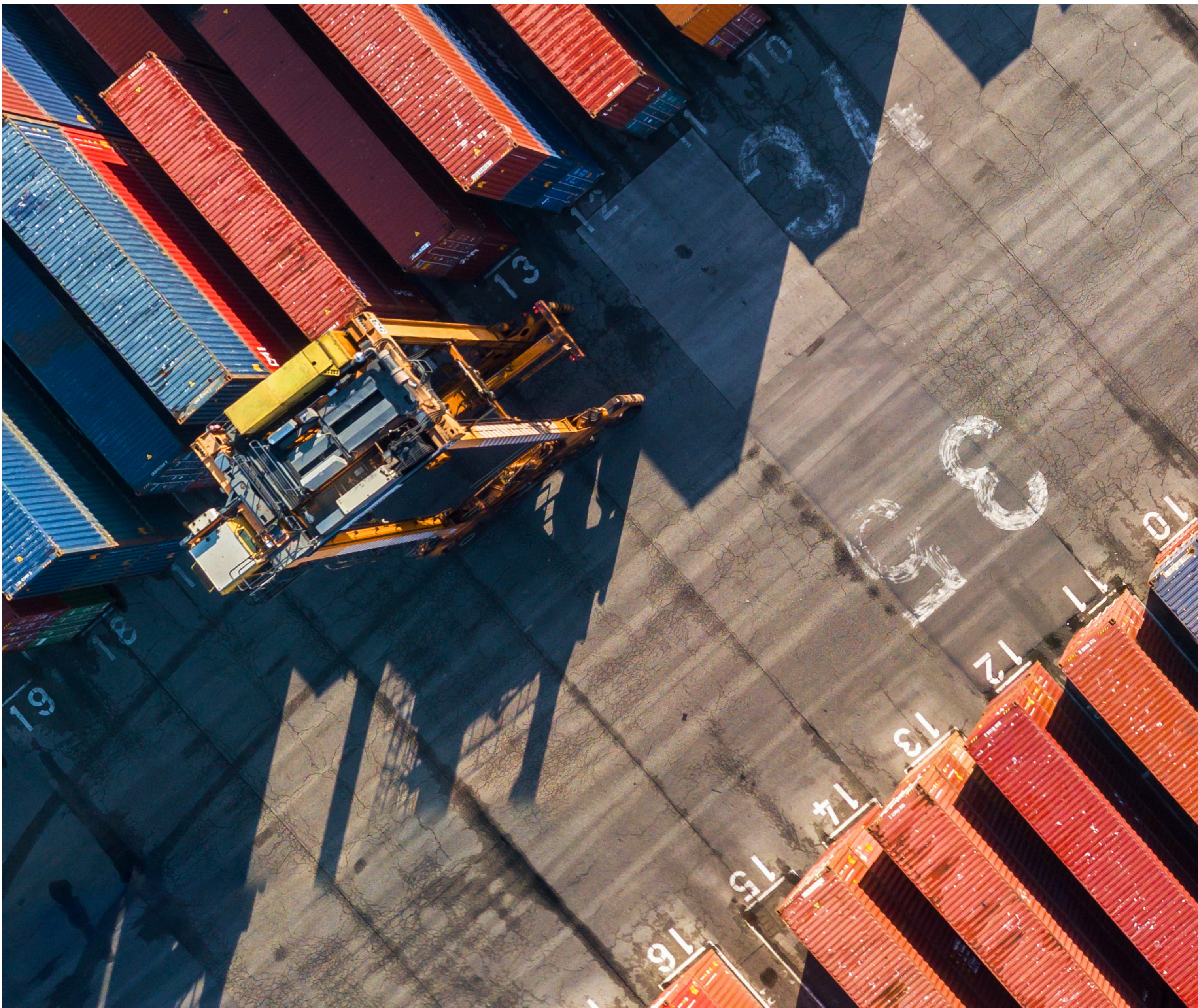
Revision of the fiscal framework. Chancellor Sajid Javid has already highlighted his intention to change the fiscal framework to allow for borrowing for infrastructure. These proposals are likely to be supported by all sides of the political divide. The challenge will be to bring forward the right projects through the planning and business case process as quickly as possible – as well as keeping existing programmes on track.

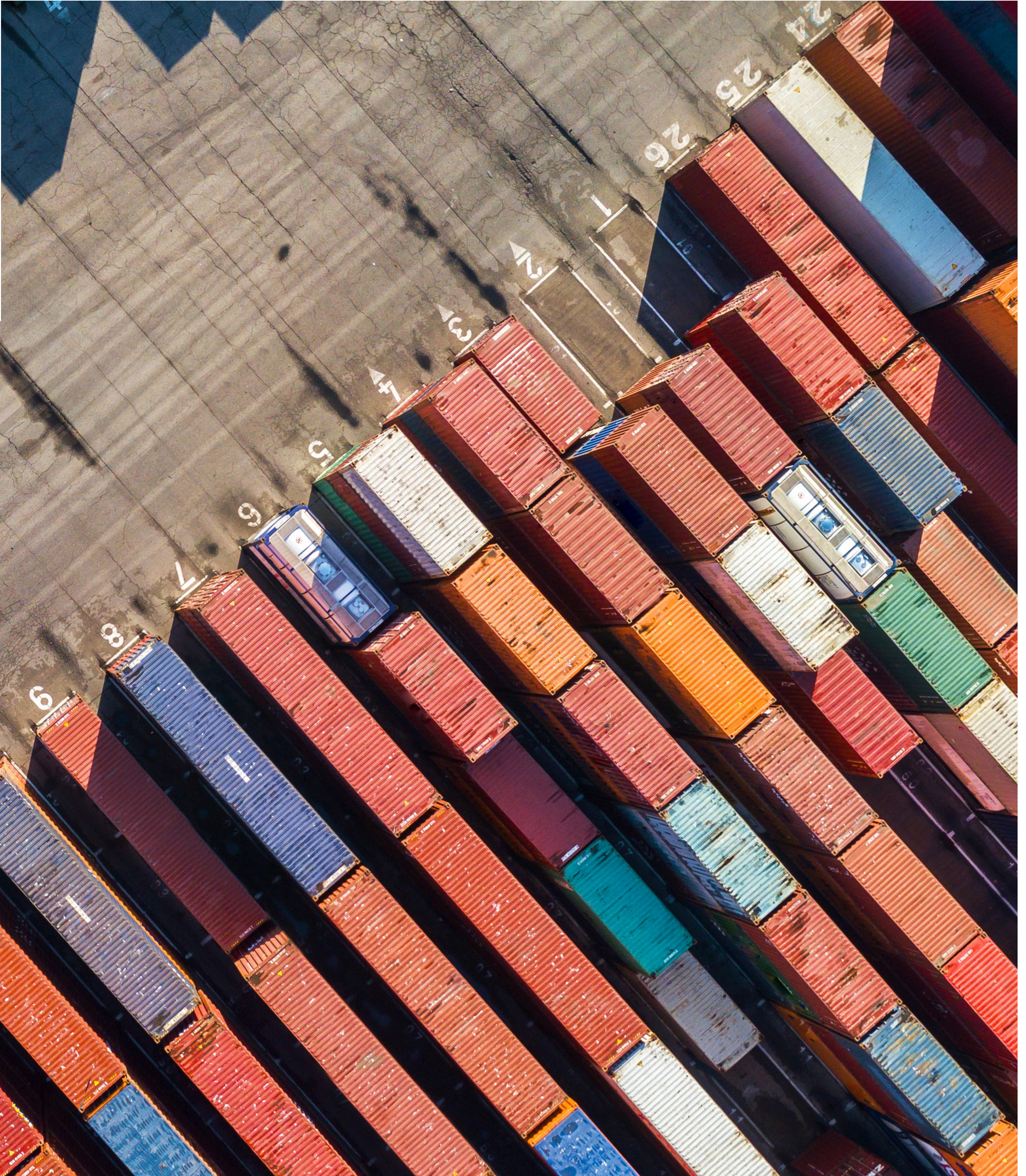
Talent development and upskilling programmes. Investments in education, including a renewed focus on vocational skills through the launch of the T-Levels programme in 2020 will play an important role in boosting UK capacity by developing replacement capacity.

This is of course a long-overdue, but also long-term programme which won't deliver outcomes for some years.

These moves highlight that some quite significant measures could be taken in the next 6-12 months to turbo-charge the UK economy. Of course, the opposition proposes even more radical suggestions for the economy, which are likely to take much longer to enact and will have a slower but more far-reaching impact.

As the UK prepares for the next phase in the unwinding of its relationship with the EU, close monitoring of economic thinking by all parties will provide a valuable input into business planning.





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