ARCADIS
Design & Consultancy
for natural and
built assets

MARKET VIEW
BREXIT-MANAGING THE UNCERTAINTY

WINTER 2019

The construction sector continues to gear up for Brexit. However, the post-Brexit trading environment remains unknown, underlining the need for agility and flexibility.

Assuming the successful conclusion of a deal, the UK construction industry still has the opportunity to plan, think about and implement measures now, in order to take full advantage of the post-Brexit marketplace.

Our view on the most likely Brexit scenario

Our working assumption is that a so called 'soft Brexit' will prevail in 2019. We anticipate this to be a version of Theresa May's Brexit deal that is agreed in 2019. Inevitably this view is subject to change given the pace of events and scale of uncertainty.

Under this version of Brexit, our forecast scenario is:

- GDP growth of 1.5 to 2.0% (2019);
- Sterling steady against a basket of currencies in 2019;
- Inflation at approximately 2.0%;
- Bank rate held at 0.75%;
- Increasing real rate of household income growth to 1.4%;
- Public sector net borrowing down by £3bn.

This is a relatively benign-to-positive outlook based on the continued application of EU rules during a transition period. However, over the longer-term any barriers to trade resulting from Brexit are likely to reduce growth rates and national wealth.

What's the construction market demand outlook under this scenario?

The UK economy, fifth largest in the world, has demonstrated remarkable resilience since the referendum in 2016. The UK economy is forecast to grow 1.5% in 2019. To put this in context, it compares well with economic growth forecasts for peer-economies including France, Belgium, Germany and Italy with expected growth in 2019 of 1.6%, 1.4%, 1.6% and 0.9% respectively.

The UK maintains a strong global reputation as an attractive place for investors. For the second year in a row, the UK has the top spot in Forbes' 2019 Best Countries for Business rankings.

Additionally, according to the latest World Economic Forum Global Competitiveness Report, the UK is 8th strongest globally, being highlighted as a beacon of innovation.

Even with all the above being true, deep uncertainty associated with Brexit is undoubtedly taking its toll on sentiment and the economic outlook. Coupled with solid signs of a global economic slowdown, there are continuing downside risks to future UK economic performance. However, in the short-term at least, a positive conclusion to Brexit talks should give the UK economy a welcome boost.

UK Construction Demand

There is a degree of nervousness in construction client organisations, and whilst projects and programmes are still being progressed, there is some evidence of pause in anticipation of greater certainty emerging in the next 3-6 months.

That said, UK construction output continues at a historically high level, which has perpetuated capacity constraints and deliverability challenges. However, the rate of growth is forecast to stall. The Construction Products Association (CPA) expects total construction output to grow 0.2% and 1.6% in 2019 and 2020 respectively.

2019 could turn out to be the weakest market since 2012, and although overall levels of activity will be healthy, the aggregated numbers do hide sectoral variation. For example, office construction is expected to decline in 2019 and 2020, whilst retail, which is already weak, is expected to remain flat. On the positive side, the residential and infrastructure sectors are expected to see continued growth to 2020 inclusive.

Our Tender Price Forecast

Contractors' tender pricing decisions are influenced by direct and indirect factors. Directly, expectations about future workload as well as materials and wage inflation feature but, indirectly, a raft of other influences – ranging from the achievement of an organisation's strategic objectives to building or maintaining client relationships – also have a bearing.

How contractors weight the array of direct and indirect factors influencing their pricing decisions varies project-by-project and, at this time of heightened uncertainty, indirect factors are more influential than usual, resulting in wider tender spreads and very different pricing dynamics from project to project.

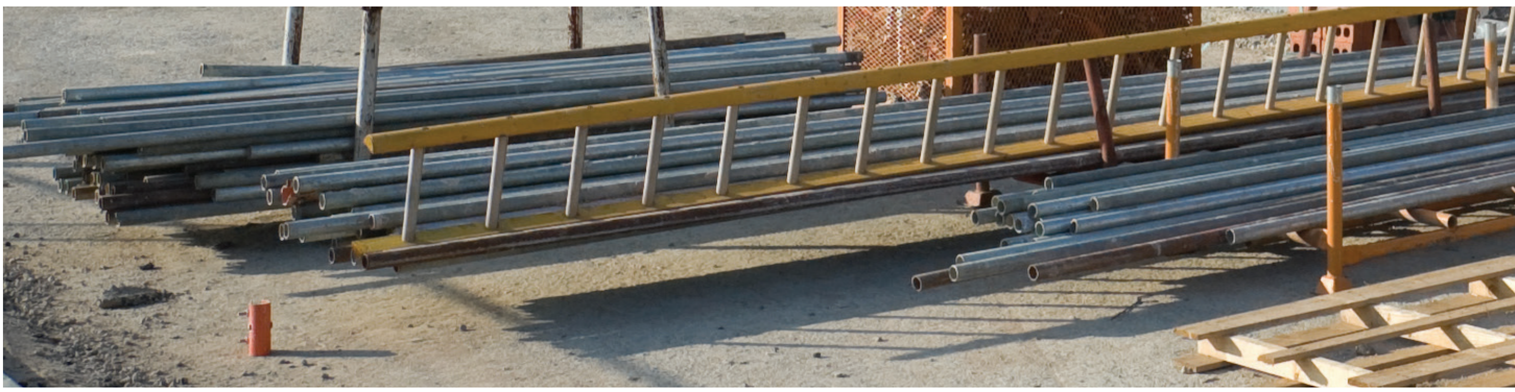
Materials and Labour Input Costs

Materials costs.

Construction materials inflation continues at circa 5% per annum. Because more than 30% of all construction materials and components are imported, Sterling's weakness continues to be a significant inflationary factor. For example, timber prices are up 30% since the EU referendum in 2016. Additionally, many organisations are stockpiling product in preparation for a potential no deal Brexit and this in itself has likely had an effect of driving demand and therefore pricing.

Labour costs.

Labour cost inflation continues at circa 3% in the year. However, some skilled trades would have seen higher rates than this. UK net migration has remained fairly stable since its peak in 2016, with around 270,000 more people coming to the UK than leaving in the year ending June 2018. However, there has been a reversal in the patterns for EU and non-EU migration. Non-EU net migration has been rising and is now at the highest level since 2004. In contrast, EU net migration has been falling and is at the lowest since 2012.



Our tender price forecast assumes a soft Brexit as described above and remains unchanged from last quarter.

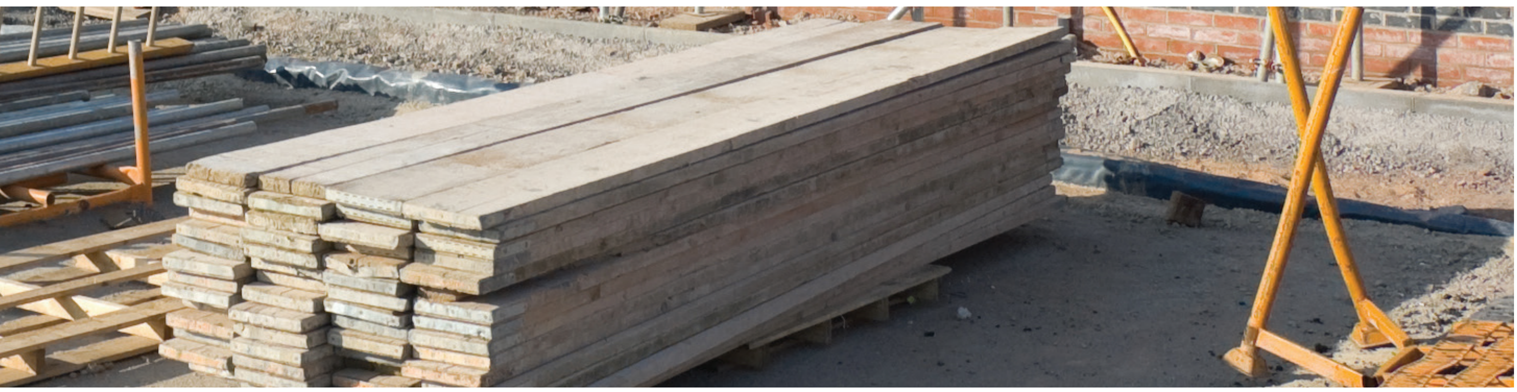
It is important to note that the forecasts presented below represent the expected average across a range of schemes and locations. It is necessary to take project specific factors into account when forming a view on tender price inflation at project level.

Our tender price forecast assumes a soft Brexit as described in this Winter 2019 Market View.

% 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	3% (3%)	3% (3%)	4% (4%)



Looking beyond Brexit

Brexit has absorbed a great deal of government, industry and organisational focus. Whilst Brexit has exposed many of the challenges and opportunities facing construction, it has detracted from the industry's ability to act on them.

Whilst resolution of the withdrawal agreement by 29th March (or later if Article 50 is extended) doesn't mark the end of Brexit, it is a pivotal moment and one that should return some focus to other areas of challenge and opportunity. What might be beyond Brexit for the industry?

Brexit bounce.

There is a view that the lengthy period of uncertainty endured by the UK since the referendum has led to the potential for a 'bounce' upon resolution of the Brexit deal. From sterling, to stocks, to property and land – UK assets arguably look relatively cheap. If the outcome is a soft Brexit, this could bring more heat back into the market with potential expansion in construction output of 5% each year in 2019 and 2020. With a market still capacity constrained and with less room for manoeuvre in obtaining skilled labour post-Brexit, we could see a return to the inflation and deliverability challenges of 2014-2016. This will only add to the need for the industry to do things differently.

Housing crisis.

The significant need for housing across the UK will continue to present an area of challenge and opportunity for UK construction. The growing private rented sector and local authority housing pipelines will further contribute to pressure on resources in the industry, coupled with continued robust infrastructure pipeline that will also demand overlapping skills. The industry's ability to deliver on these needs to time, budget and quality present challenges and opportunities.

Sector deal.

The Sector Deal is not specifically driven by Brexit but it presents a rare opportunity for clients and their supply chain to work together to improve productivity as well as the long-term performance of assets. The Sector Deal, announced in July 2018, is a national programme aimed at industry transformation, featuring government support for re-training as well as research and development focused on the wider adoption of manufacturing and smart technologies. With the recent confirmation of funding for the industry hub, the Transforming Construction Alliance, as well as the opening of the IPA's consultation on Platform-based off-site manufacture (P-DfMA), the pace of change is picking up.

Key role.

In a more fragmented and competitive world the UK construction sector has a key role to play in supporting the UK's wider Industrial Strategy. Built assets underpin the ability of all industries to innovate, grow and deliver, so the efficient delivery of these assets will remain critical to the UK's global competitiveness. Whilst it is necessary to plan for the unthinkable impacts of a no-deal Brexit, the UK construction industry must also plan and implement necessary measures to take full advantage of the post-Brexit marketplace.

Preparing for Brexit - 5 point plan

Preparing for an event with such significant political, economic and administrative consequences is challenging – the complexity of, and interrelationships between, the factors at play make it difficult to model the detail of Brexit scenarios with any certainty.

When facing such uncertainty, building a comprehensive picture of potential exposure to the challenges Brexit may present now will help to build the foundations to support an agile response to whatever post-Brexit challenges are encountered.

Our 5 Point Plan provides a framework through which project exposure can be explored and mitigation can be planned.

HEADLINE ACTIVITY	CONTEXT	KEY READINESS ACTIONS
1. Engage with the supply chain	• Availability of EU labour may change. • Prices may change as a result of EU and non-EU tariffs. • Schedules may be affected by customs barriers. • Value of sterling may fluctuate.	• Quantify the proportion of EU labour working on individual sites. • Quantify direct exposure to euro and dollar exchange risks. • Identify the extent of supply chain preparations and work with supply chain to develop understanding and build resilience and agility. • Understand sources of components and materials.
2. Review procurement strategy	• Tender pricing decisions influenced by sentiment. • Additional customs checks may cause near-term delays to materials/component deliveries. • Key events can trigger forex fluctuation. • Excessive risk transfer may attract a commercial premium.	• Understand how the critical path may be at risk from unexpected customs delays. • Achieve clarity on where commercial risks sit. • Develop mitigations addressing threats to schedule. • Review the balance of risk transfer to ensure appropriateness in relation to Brexit risks. • Understand key points in the Brexit process that could impact buying decisions.

HEADLINE ACTIVITY	CONTEXT	KEY READINESS ACTIONS
3. Review contracts for clauses	• Contractual tension may increase as a result of Brexit-impacts, raising the potential for disputes. • 'Brexit clauses' are being introduced into some contracts seeking to manage Brexit-related risks. • Increased potential for extreme contract remedies – e.g. Force Majeure or Frustration.	• Make sure contracts are signed. • Ensure contract administration practice is being conducted in accordance with contract terms. • Review contract terms and amendments for risk and opportunity areas. • Liaise with legal team to identify potentially vulnerable or contestable contract clauses. • Identify contractual exit points.
4. Undertake due diligence	• High levels of financial fragility remain in the supply chain. • Supply chain is exposed to Brexit-related financial risks. • Insolvencies are rising.	• Commission comprehensive review of current financial and deliverability status. • Review of contingent liabilities. • Contingency plans for supply chain failure.
5. Make contingency plans	• Costs may escalate significantly. • Labour supply will be reduced if free movement ends. • Imports of EU materials will be more costly. • Disruption to logistics and programme.	• Organise contingency funds against identified risk areas. • Review schedule and deliverability to develop contingency plans.

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Arcadis

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