FAITHFUL GOULD

Member of the SNC-Lavalin Group

CONSTRUCTION INTELLIGENCE REPORT

2ND QUARTER 2023

CONTENTS

INTRODUCTION

Compared to the past 3 turbulent years, 2023 has been a relatively calm year. The absence of global pandemics has meant that we have been able to draw a breath and steady the ship. We can finally look ahead and focus on the current environment and the important challenges that we face.

On a wider political level, the impact of rising inflation coupled with a year of political instability saw the UK economic recovery peter out amid rising interest rates and a cost-of-living crisis. The primary concern is the persistent high inflation that we face; May saw the disappointing news that CPI inflation remains at almost 9%. We must acknowledge that whilst looking at inflation through our construction lens, in the last 3 years we have seen the BEIS Construction Material Index rise by 41% because of material unavailability, extra shipping costs and delays, and the Ukraine conflict.

Construction has been one of the few bright spots in the UK economy since the start of 2020. Even after the problems of the last 3 years, construction output was 6% higher at the end of 2022 than at the start of the decade. This is changing with forecasters for this year predicting a fall in output, with private housebuilding bearing the brunt of the economic downturn.

The good news is that supply chains continue to improve with lead-in times for most goods having returned to pre-pandemic times. Better material availability coupled with reduced demand has meant that the rate of material increase has slowed. The order pipeline remains steady albeit there is a reduced stream of projects coming through.

OUR FORECAST

When we undertook the exercise for our tender price inflation forecast, we assumed that the UK would fall into recession during 2023. The economy has proved more resilient than the OBR forecast in November 2022 predicted and while we may escape a technical recession, growth will be negligible before an expectant modest recovery in 2024.

Although recent economic forecasts have been slightly more optimistic, we have continued to see persistent high inflation causing interest rates to creep higher. The Bank of England has continued to rise interest rates to combat inflation and May saw them increase to 4.5%. While there is speculation that this increase may be the last in this economic cycle it is impacting on investment, both public and private, and this will continue to subdue the market.

As a result, most forecasters are predicting that construction output will fall this year; this is confirmed with reports showing that the volume of material sales continues to fall and starts on site have also dipped.

We have factored in the Ukrainian conflict continuing, but a year into the struggle most stockists have found alternative sources, commodity prices have returned to pre-March 2022 levels and appear to have stabilised. This is backed by the CLC reporting that material availability is now mostly at 2019 stock levels and lead in times. The main exceptions being products relying on semi-conductors and sustainability goods, such as photovoltaics.

Labour availability and its effect on costs will replace materials as the main cost driver, as the industry continues to struggle to recruit workers. The UK Government has finally succumbed to industry pressure and loosened visa restrictions, for some trades, for overseas workers. However, like the rest of Western Europe, the situation remains chronic with the need to recruit at all levels and professions in the sector.

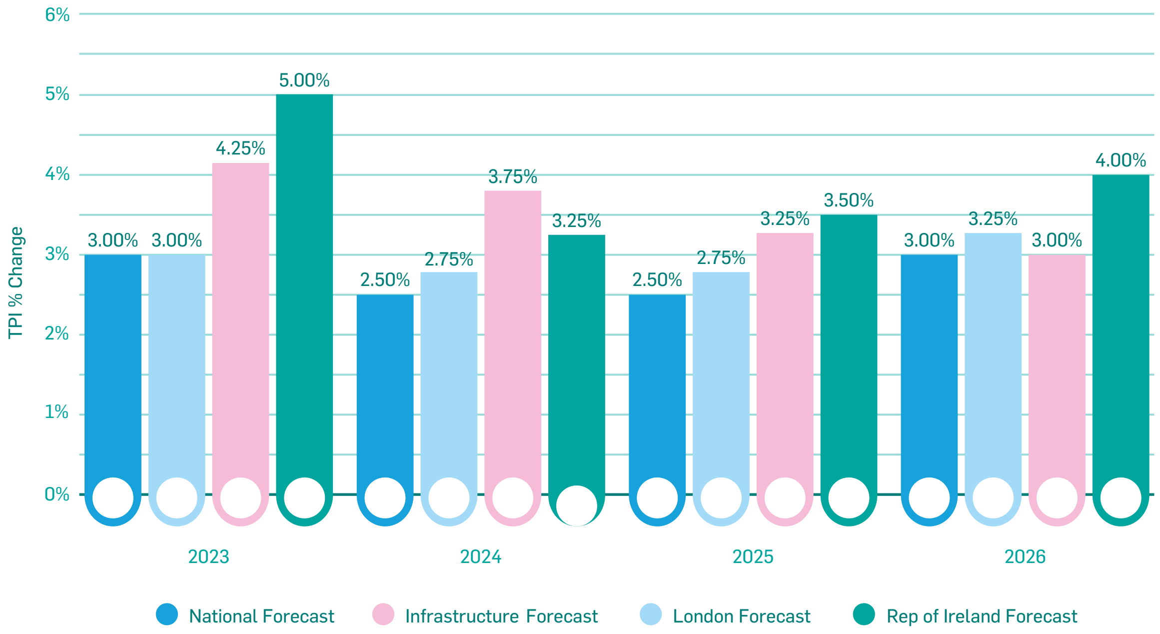
Reduced demand coupled with better material availability will see increased stability for material pricing platforms. While year-on-year inflation continues to fall, the BEIS Construction Material Index saw a 4.7% increase from April 2022 to 2023, a vast drop from the 26% increase we saw in June and July 2022.

2023 will continue to provide tough-trading conditions and with continued uncertainty regarding the level of new orders and inflation we are maintaining our CIR Q1 forecasts.

F+G TENDER PRICE FORECAST 2023-2026

TPI FORECAST	2023	2024	2025	2026
National	3.00%	2.50%	2.50%	3.00%
London	3.00%	2.75%	2.75%	3.25%
Infrastructure	4.25%	3.75%	3.25%	3.00%
Republic of Ireland	5.00%	3.25%	3.50%	4.00%

F+G TENDER PRICE FORECAST 2023-2026



INFLATIONARY PRESSURES

As stated at the beginning of this report, we are seeing continued inflationary pressures, however, we are now seeing that the levels are decreasing.

The recent BEIS Construction Materials Indices published for April, showed the rate of increase in the last 12 months was only 4.7%, which is the lowest yearly increase since April 2021.

BEIS CONSTRUCTION MATERIAL INDEX 12 MONTH INCREASES

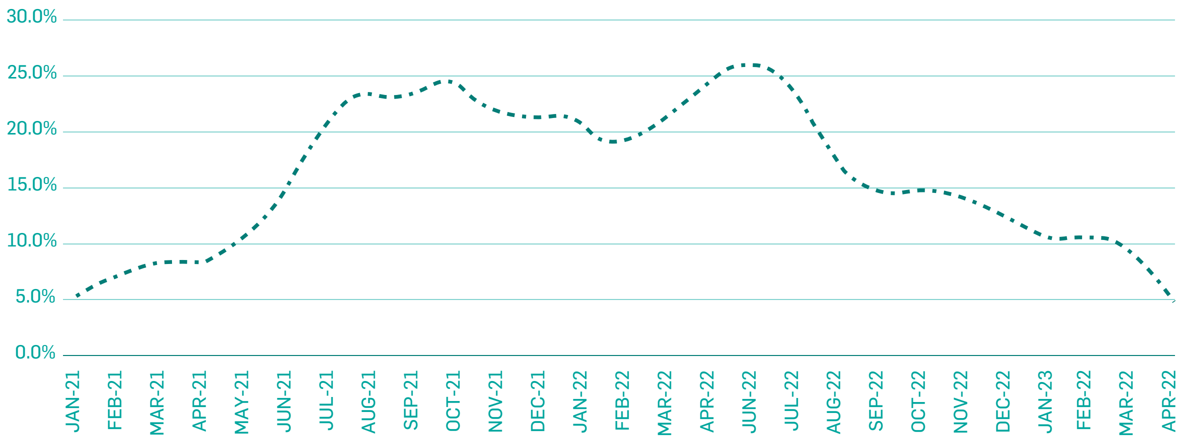


Figure 1 – Source BEIS

This was assisted by better material availability, improved lead in and stock levels and a global slow down. Reduced demand will also assist in easing the pressure placed on the material and labour supply chains and its cooling effect on inflation, as the ability for suppliers to pass on price rises and transient labour leaving for better pay is diminished.

If we look back at the increases and plot them as a cumulative increase, we can see that material prices have risen by over 40% since January 2020. Also, the inflationary increases form a distinctive pattern that we will discuss later in this report.

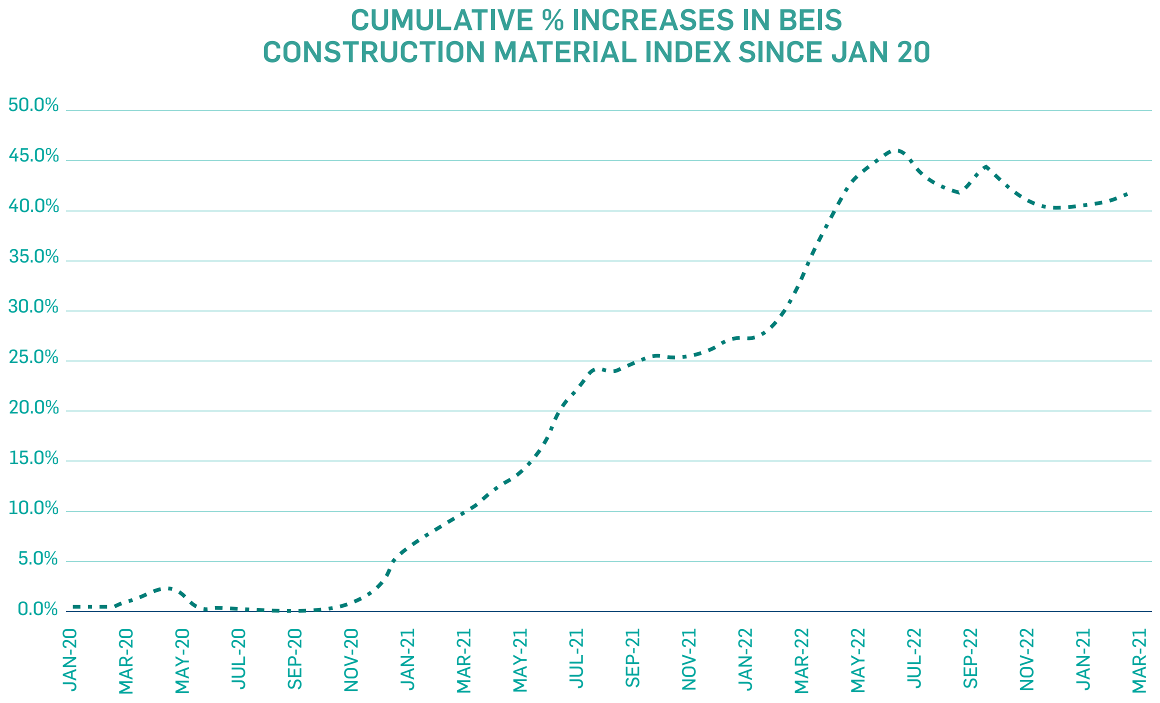


Figure 2 – Source BEIS

The drive to energy efficiency and decarbonisation, especially in the residential subsector, means some materials are still experiencing shortages, eg, photovoltaics and insulation has seen considerable price increases with demand still soaring.

With a shortage of construction skills throughout the sector, not just site skills, but also professionals, we anticipate that labour costs will become the major cost driver, the BCIS is predicting wage agreements in the region of 7-8% this year, although the actual site pay will be tempered by a slowdown. Going forward the UK Government has acknowledged the chronic skills shortage we face and has started to relax the visa requirements for several trades to work in this country. The list will probably increase in the next few years as the wider economy improves and construction output increases again.

Inflationary costs are not just calculated from pure material and labour increases, they are based on a myriad of other influences: profit margins, allowances for risk, the wider economy pressures, and naturally, the desire of the contractor to secure turnover and win projects.

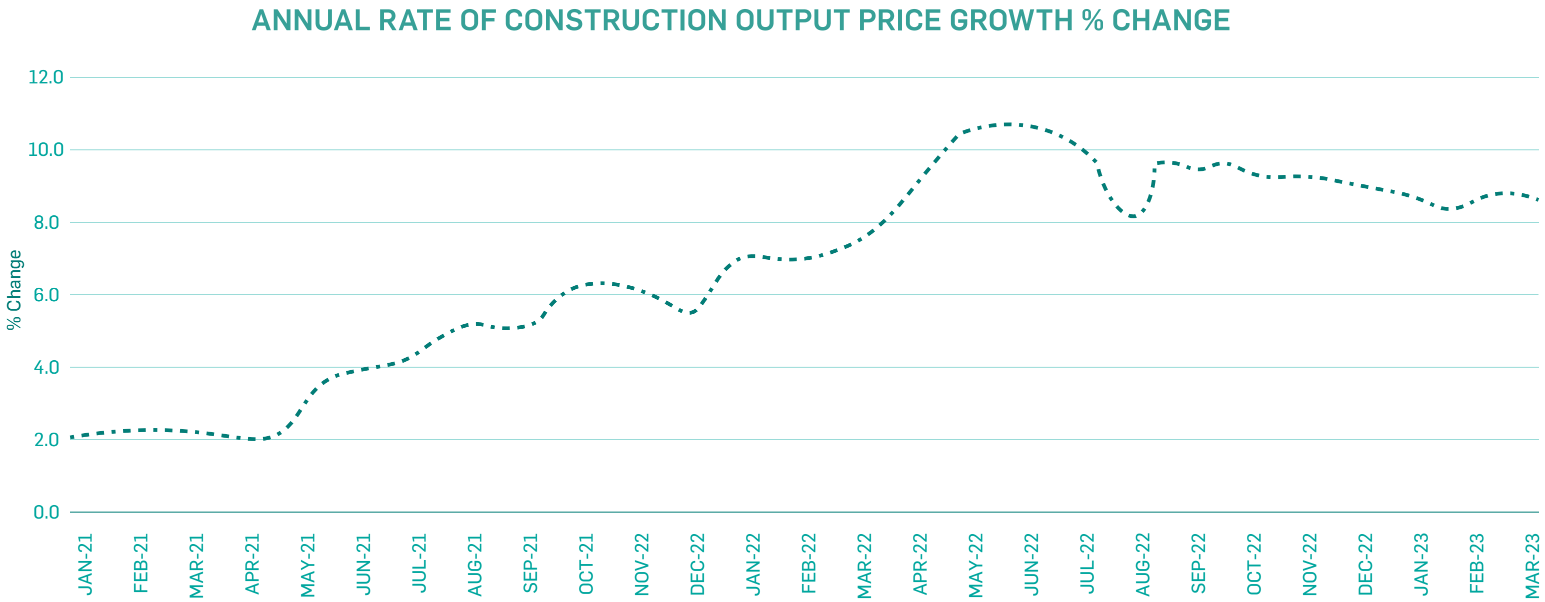
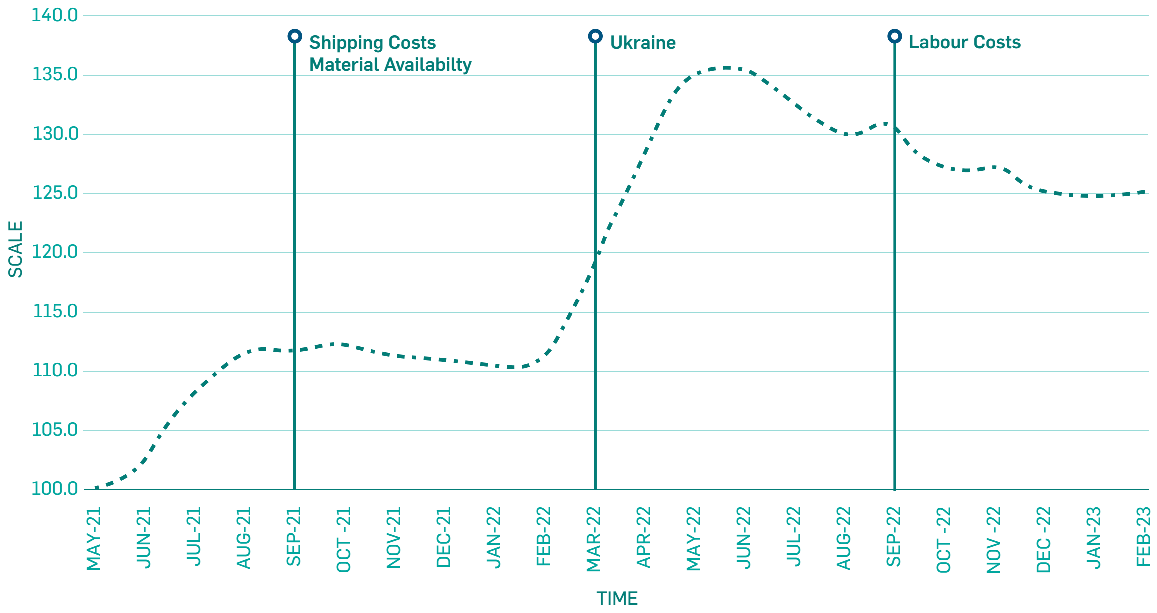


Figure 3 – Source ONS

The ONS produces the Construction Output Indices, which includes costs for materials, plant and labour, and allows a mark-up for commercial decisions. Like the BEIS index we can see that inflationary pressures have peaked and are coming down, although the increasing importance of labour provides a different shape.

In undertaking this exercise, we used the previous two graphs; by overlaying these graphs produced similar curves that mirrored the events that were witnessing these results. Whilst the timing and scale of the different components differ, there are distinct inclines because of material inflation and shipping costs before a short period of relative stability. This changed as the effects of the Ukrainian conflict emerged. Most charts seem to have peaked and falling inflationary trends have emerged.

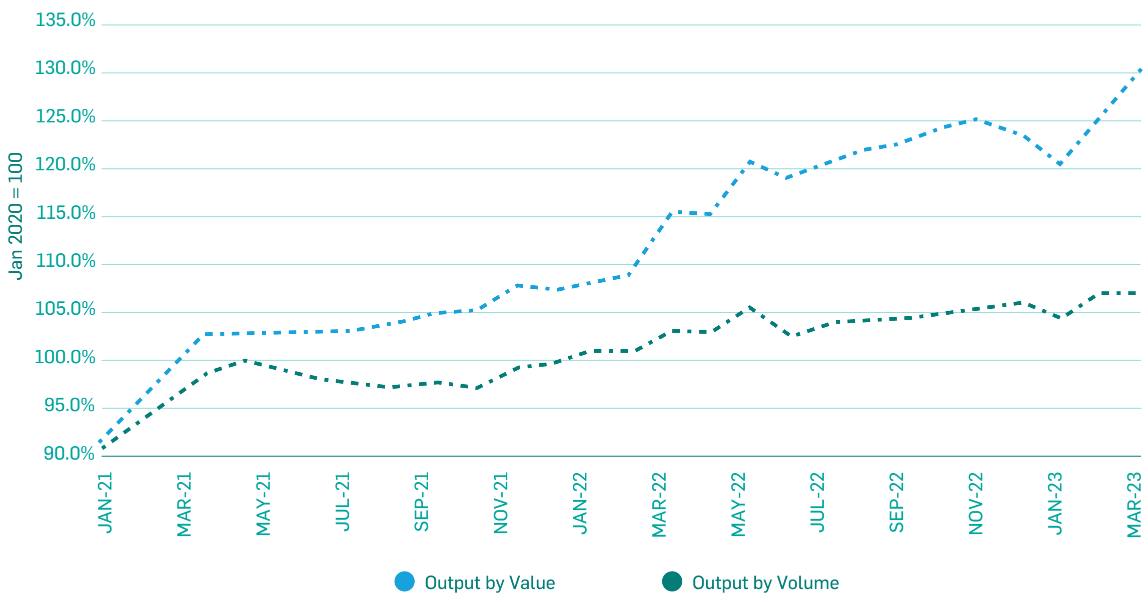
GENERAL INFLATION TIMELINE



CONSTRUCTION FORECAST

The latest ONS figures released in May for construction output showed that the volume of construction output has increased by 6% since January 2020. During the same period, we have seen the actual value of work increase by almost 30% because of the inflationary pressures that we witnessed.

CONSTRUCTION OUTPUT – VOLUME AGAINST VALUE



Whilst construction output has risen in 2023 so far, the construction sector is expected to reflect the wider UK economy in the rest of the year and see a decline in output. Most forecasters are predicting a fall in output with public and private housing being the main contributor to the decline, with Experian forecasting a fall of 4.5 and 7.5% respectively in these subsectors because of higher interest rates and reduced household expenditure.

The headline figure does not reveal the full story, given that public and private housing new build and R&M account for 45% of the construction sector, any downturn in these subsectors will have a particular weighted impact on the overall sector. Experian forecasts that the other subsectors will increase, albeit marginally in 2023.

CONSTRUCTION OUTPUT BY SECTOR

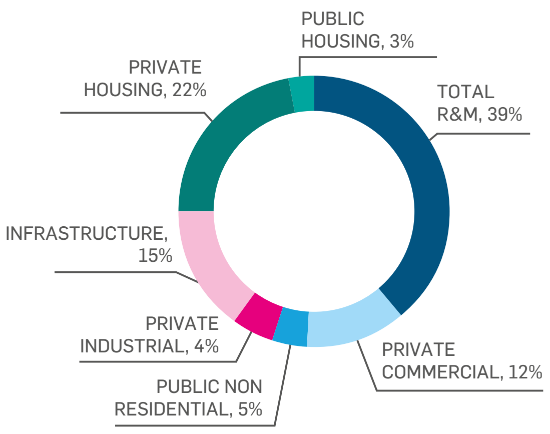


Figure 4 – Source ONS

EXPERIAN CONSTRUCTION OUTPUT FORECAST

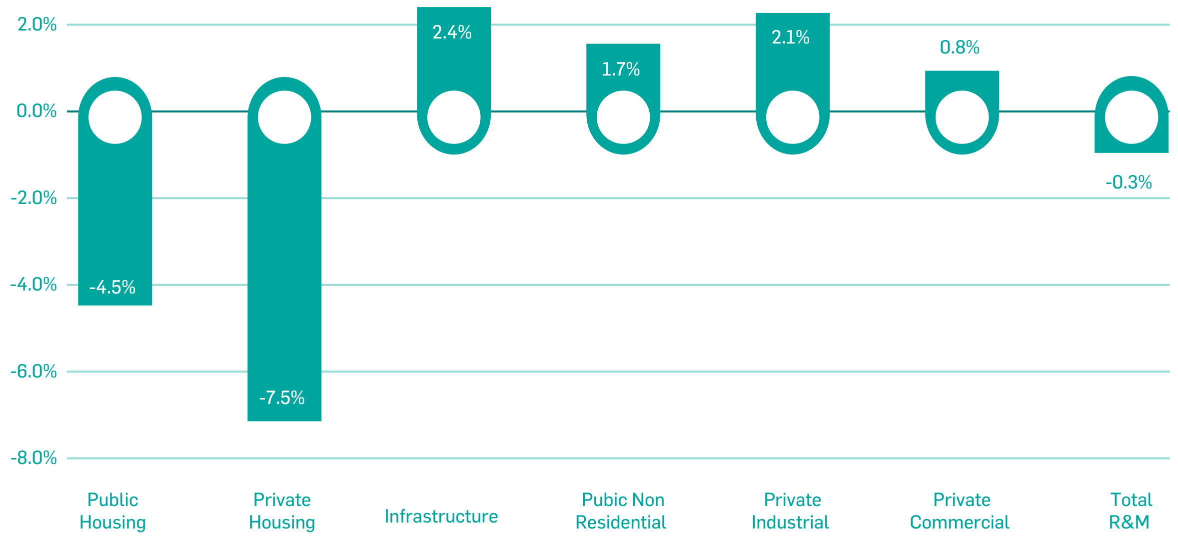


Figure 5 – Source Experian UK Forecast Spring 2023

LOOKING AHEAD

Max Wilkes
ASSOCIATE DIRECTOR

Currently we are at a crossroads; recent figures show the wider economy is performing slightly better than anticipated and economic forecasts have been revised slightly upwards. While inflation remains high, there are signs that it will start to fall through the second half of the year as the effects of energy price hikes from last year fall off the trackers.

Whether interest rates will follow is uncertain as the Bank of England strives to reach it's 2% CPI target; currently analysts are predicting that they will remain around this level until next year. This will have the effect of dampening both public and private investment across all subsectors.

IN SUMMARY

- Material sales and start on sites have fallen.
- Private housebuilding has seen a downturn with fewer starts and future developments put on hold.
- There has been a continued high rate of insolvencies.
- In May the RICS reported that workloads were beginning to increase; the figures of the S&P Global/CIPS UK construction PMI figures showed a rise in purchasing (this remained above the critical 50 value, which indicates growth in the sector).
- Build to rent (BTR) and student accommodation subsectors remain strong especially outside of London.

There were common messages from both with infrastructure and commercial projects leading the way, but private housebuilding in both surveys showed continued decline. This sector will continue to experience deflated output as the economy struggles with weak demand and higher borrowing costs. While experiencing problems, house prices haven't crashed as some forecasters predicted and some housebuilders have reported encouraging figures that the key metric of sales per plot per month are increasing.

Insolvencies remain a considerable problem, the latest figures show no improvement with specialist installers continuing to contribute over half of the total insolvencies. Although the problem of rampant material inflation is now easing slightly the reduced demand and higher interest rates will continue to erode margins and ensure cash flow problems continue.

With the economy generally enjoying a period of growth since the end of the first lockdown we witnessed contractors being selective with the projects that they wished to tender for whilst attempting to manage risk in a volatile marketplace. Entering the second half of 2023 with the economy slowing down and investment falling we are seeing that contractors are looking to secure turnover for 2024 onwards. We are now experiencing contractors enquiring about projects coming through the pipeline and with it they are reporting that the supply chain below them is approaching them.

With developers within the private sector reappraising projects many contractors are now looking at the public sector for work and bringing increased competition for the work. It appears that there is a growing appetite for tendering within the sector.

Whilst 2024 will see a modest growth assisted by the anticipated recovery in housebuilding the next few years will be testing and remain sluggish. We may have seen tender price inflation peak in this economic cycle and with the economic slowdown tender price increases have returned to more historic levels. Having passed through periods where material unavailability, shipping problems and then high energy costs caused by the Ukraine conflict, we have now entered a period where labour costs and supply will emerge as the main problems.

Although we have seen downward trends in many of the factors influencing output costs, we need to remember that costs are not falling, merely increasing less rapidly.