ARCADIS

A Long Way Back

UK Construction
Market View

Autumn 2020

Introduction

After a sudden and rapid hit from COVID-19, construction output has been recovering steeply in recent months. But can this growth be sustained?

- Following a dip of -19.8% in Q2 2020, the UK economy has been recovering strongly throughout the summer months, with an average GDP growth of 7% in June and July. August signalled a significant slowdown, with a modest reading of 2.1%, and output still 9.2% below pre-COVID-19 levels. The Organisation for Economic Co-operation and Development expects the UK economy to shrink by 10% in 2020, and the Bank of England anticipates a return to pre-COVID levels only in Q1 of 2022. A slower than expected recovery will be negative for construction, denting both confidence and demand from the wider economy.
- The IHS/Markit Purchasing Manager's indices for September all remained in expansion territory, with values of 54.1 for manufacturing, 56.1 for services and 56.8 for construction. These optimistic readings reflect the short-term bounce-back that took place over the summer. Long-term investment plans are less positive. As indicated by the latest Deloitte CFO Survey, defensive strategies are predominant, with 65% of respondents expecting a reduction in capital expenditure – despite the availability of relatively cheap credit.
- The Coronavirus Job Retention Scheme ends on 31st October 2020 and will be replaced with the Job Support Scheme, which applies to employees that can return to work for at least 0.2 FTE . So far, the rise in unemployment has been modest, with an increase from 4.0% in March to 4.5% in July. However, the new scheme is meant to support only 'viable jobs' and it is expected that unemployment will reach 7.5% in 2020. Construction has already seen a decrease in vacancies by 13% compared with 2019. This will take pressure off wage inflation.

- A surge in COVID-19 cases since the beginning of September, especially in the northern regions, led to the introduction of the three-tier emergency system and local lockdowns with different grades of restrictions. Work on construction sites mostly continued uninterrupted during the summer months, but is likely to be disrupted again by a combination of newly announced limitations, especially restrictions to travel, and seasonal limits to working hours. It will become harder for contractors to maintain existing levels of productivity and turnover this winter.
- After a 40% decrease in output reported in April, the construction sector began a steep recovery helped by the need to catch up on work lost during the first lockdown. The month-on-month growth rate in both June and July was 20%. However, this trend eased in August, with 3% growth, leaving a gap of 10.8% compared to pre-COVID levels of activity. Given that productivity levels are down by around 10-15% as a result of new Site Operating Procedures, this is an impressive recovery. However, looking forward it might take longer for activity, employment, and profitability levels to recover.
- The Construction Products Association has upgraded its forecast for 2020 from -21% to -14.5%, but still does not expect to see 2019 levels of activity before the end of 2021. The outlook for new orders is still uncertain and construction is likely to be very dependent on the ability of the public sector to maintain progress across a wide range of investment programmes.
- The recently announced change of the Comprehensive Spending Review scope could undermine the industry's confidence with a regard to a government funded investment programme.
- On top of the challenges brought by COVID-19, the UK is inevitably approaching the end of the transition period in its relationship with the EU. At the moment of writing, the negotiations on the new deal are still ongoing. In the case of no-deal, a turbulence to sterling value and disruption in access to materials and labour can be expected in the first half of 2021.
- Driven by different levels of demand, construction is likely to temporarily become a "two-speed" industry, with sectors characterised by high growth rates, such as infrastructure, and a group of 'slow-growers' including industrial and commercial. Even housing faces headwinds in 2021 with changes to the Help to Buy scheme and withdrawal of cuts in Stamp Duty. The implications are likely to include an increase in competition for workload across the buildings sector, as well as a shift of resources towards the more dynamic infrastructure sector.

Basis for the forecast

Remarkable growth over the summer

Following the dip in output in April 2020, the summer months brought substantial recovery and renewed optimism to the construction sector. The output during May-July grew at an impressive pace, driven by the release of pent-up demand. But new investments in many sectors are under review, and the outlook for new orders remains uncertain. Clients also face their own set of challenges, ranging from the validity of business cases to the potential impact of Brexit. The pace of recovery will not be equal, with the promise of acceleration of public investment and the potential for further delays in private sector workload. In the short-term, the combination of these factors tilts the equilibrium towards further deflation in buildings and slightly higher inflation for infrastructure.

Over the last six months, construction has been subject to multiple extremes – a dip in output in April 2020 (-40% compared with March 2020) was followed by sharp increase of an average 20% in June and July. The sectors that recorded the most impressive bounce back were housing (+142%), commercial (+44%) and infrastructure (+30%). Housing especially benefited from the stamp duty holiday, while infrastructure, aided by HS2, accelerated into year-on-year growth. These indicators contributed to returning optimism among Purchasing Managers, reflected in high UK Construction PMI readings – 54.6 in August and 56.8 in September. However, increased workload still leaves a gap of 10.8% in output compared to 2019 levels. Additionally, the unclear future workload pipeline indicates that the optimism suggested by recent PMI readings may prove premature.

Subdued demand creates uncertain outlook

Q2 2020 - the peak of lockdown - marked a sharp fall in new orders (-50.1%) compared with Q1. A sharp up-tick in orders in the third quarter is crucial for recovery. However, a recent internal Arcadis survey indicates that 80% of major contractors face static or slowing workload over the next 12 months. This suggests that the summer bounce back was driven mainly by a catch-up on work delayed by the first lockdown.

A long-term recovery depends on returning demand – and this is likely to be uneven across sub-sectors, leading potentially to creation of a dual-speed sector. The latest CPA forecast illustrates this clearly – infrastructure and public non-housing are set to suffer the smallest blow in 2020 (-3% and -8.5% respectively) and the former is expected to increase by around 30% in 2021. By contrast, industrial and commercial sectors will suffer an almost 20% hit to output this year, and their recovery is expected to be much slower. This is especially the case for the commercial sector, which is anticipated to expand by just over 5%.

As often happens in recessionary times, the public sector is expected to step up and become a key source of demand to help keep the construction sector going – until the private sector kicks in again. The Government has indicated on multiple occasions that it is willing to stand up to this challenge and continue investing – underpinned by the availability of cheap credit. However, with a potential hard Brexit and the costs of COVID-19 not clear, nothing is yet certain and the visibility of a long-term new work pipeline will not improve before the Public Spending Review.

In the meantime, private sector clients will need to evaluate the impact of COVID-19 on the validity of their investment plans. Clients that decide to progress with projects are likely to be more careful, bearing in mind the expected challenging economic and political situation following the UK's departure from the EU. Demand is likely to take longer to return than many would wish.

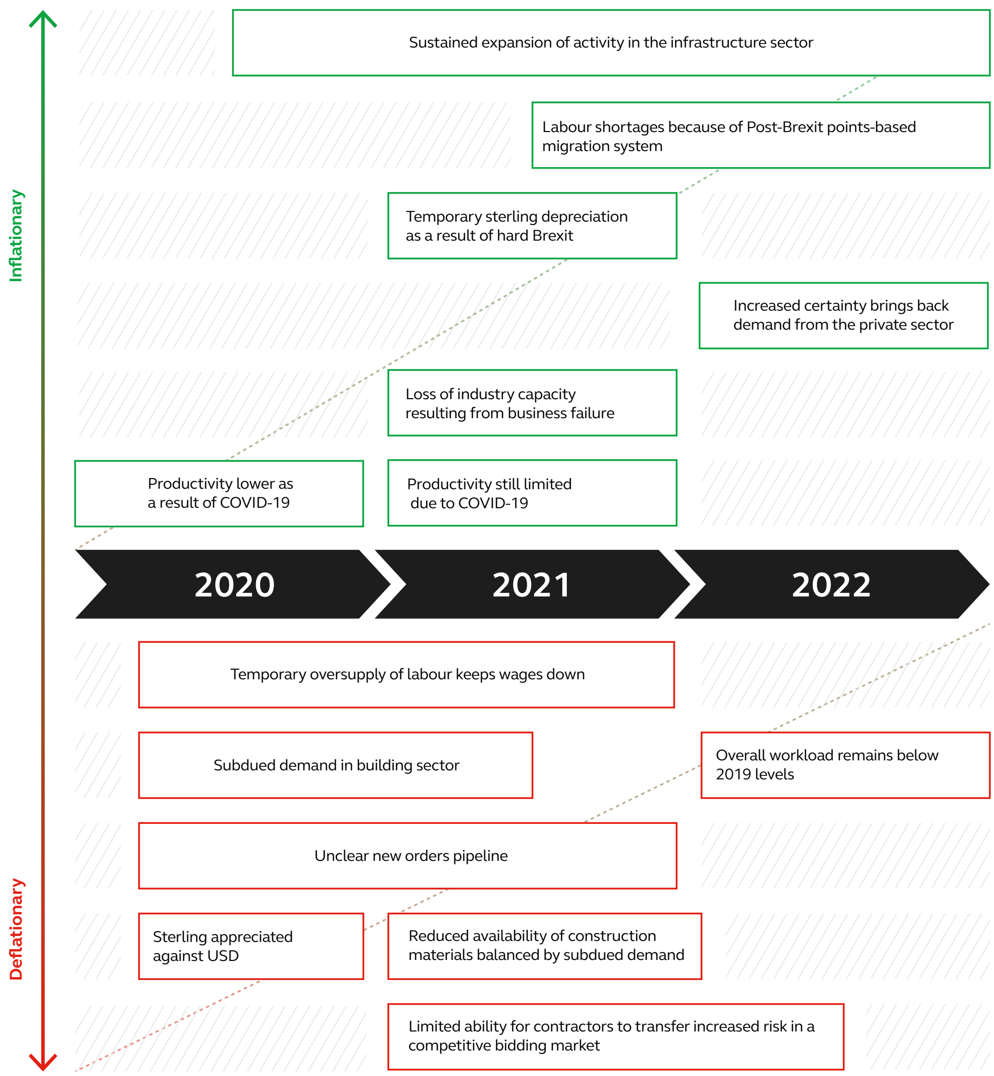
Forecast

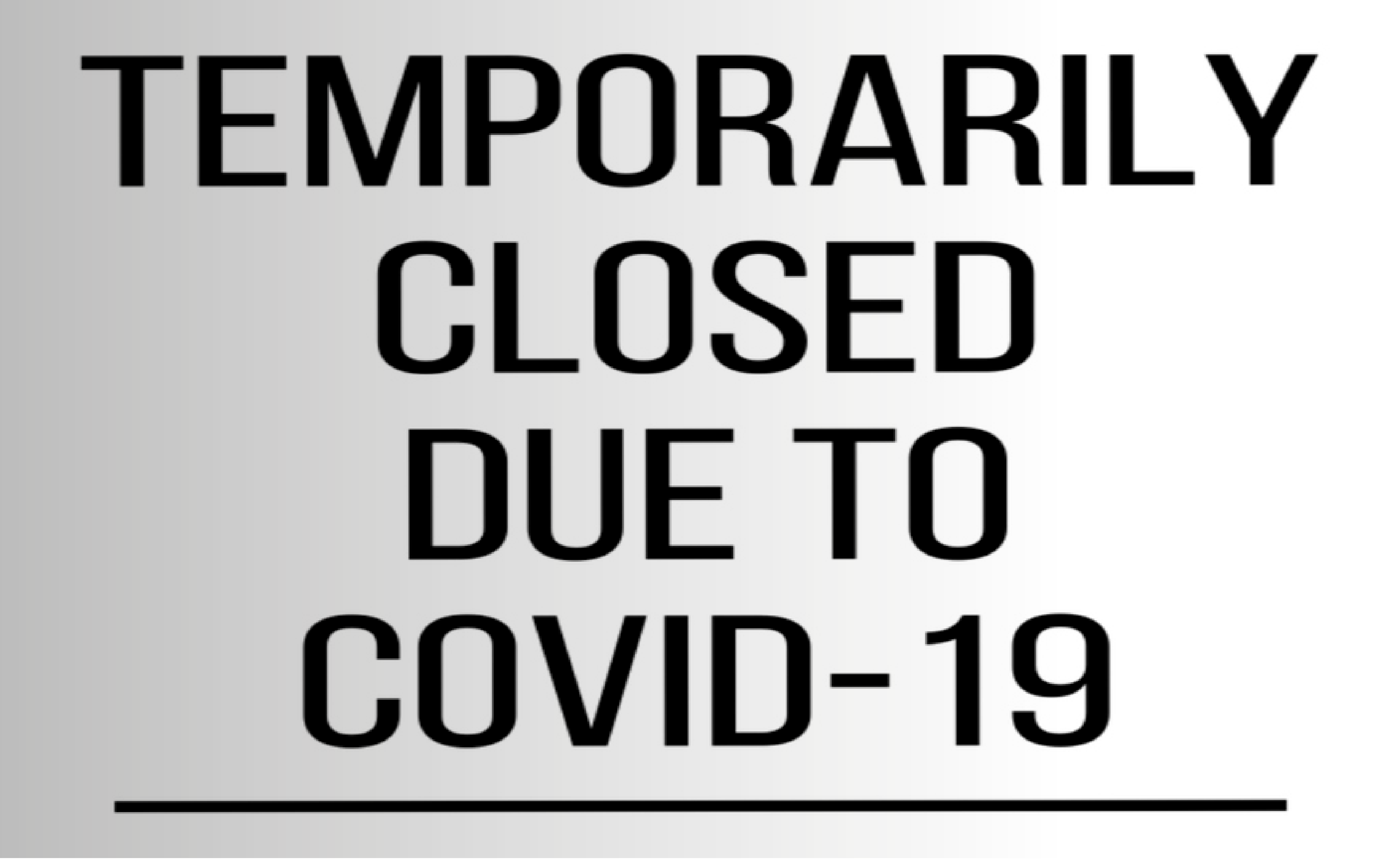
Short-term deflation for buildings, while infrastructure prices keep growing.

Our Summer Forecast advocated a Swoosh-type recovery scenario, although in two versions – an optimistic and pessimistic scenario.

At this stage, we are refocusing on a single version of events, and adopting the less optimistic approach, underpinned with slower than anticipated GDP growth and a weak new orders pipeline.

The introduction of local lockdowns in response to the second wave of COVID-19 is likely to add to uncertainty about how sustainable any economic rebound will be – which in turn will impact construction demand. In the short-term, we see a predominance of deflationary factors but, with time, an inflationary trend is going to be re-established.





The balance continues to shift towards a deflationary trend for buildings. This is mainly driven by an uncertain new work pipeline, the timescales needed to mobilise public sector investment (such as the much-touted new hospitals investment programme) and - understandable in current circumstances - weak risk appetite from the private sector. These conditions will, in the short term, help to offset inflation caused by lower productivity and Brexit. In the long-term however, we still predict the return of above-trend inflation from 2023, likely driven by the return of demand in combination with a slightly constrained labour market.

Infrastructure, on the other hand, maintains its favourable position, underpinned by a number of cyclical investments coming to fruition, such as AMP7 in the water sector, CP6 in Rail and RIS2 for highways. The outlook here is more positive, and this is reflected in our upward correction for inflation in 2021 and 2022.

	Regional Building Construction TPI	**London Building Construction TPI**	**National Infrastructure Construction TPI**
2020	-3% (-3%)	-4% (-4%)	0% (0%)
2021	-1% (-1%)	-2% (-1%)	2% (1%)
2022	2% (2%)	2% (2%)	3% (2%)
2023	3% (4%)	4% (5%)	5% (5%)
2024	5% (5%)	5% (5%)	5% (5%)
2025	5% (5%)	5% (5%)	5% (5%)
Total	11%	10%	20%

Zoom into:
Brexit - the final call

Managing the second wave of COVID-19 and its consequences will be a top priority for businesses, but impacts of Brexit must be managed in parallel.

Over the last four years we have witnessed multiple deadlines, cliff edges and scenarios related to Brexit. The initial upset, however, seems to have eased over time and we have become familiar with uncertainty. What this means, unfortunately, is that many companies have lost vigilance. The distraction from Brexit was further driven by the 'here and now' urgency of addressing the consequences of COVID-19 and, for many, the last few months were about survival, rather than preparing for a new relationship with the EU. But time flies and, with no possibility of a further extension, we are heading for the final cliff edge on 31st December.

We published the first version of our 5-point Brexit preparation plan almost two years ago and the recommendations are still valid. However, what we did not predict is that the ultimate 'exit' will be taking place in the middle of a global pandemic and during the biggest economic crisis in post-war history. This, of course, adds to the already established list of Brexit-driven risks. In response, we decided to review the original 5-point plan, and below we present an updated version that takes into account recent developments.

The recommendations in our plan are just as relevant to mitigate the impact of the final split from the EU, as the pandemic. Implementing them will help to increase overall business resilience.

Engage with the supply chain

What is going to happen?

- Availability of EU labour will change because of Brexit, COVID-19 and points-based migration system.
- Prices may change as a result of UK tariffs or quotas.
- Schedules will be affected by delays at the border as well as Site Operating Procedures and local lockdowns.
- Value of sterling may fluctuate due to increased uncertainty.

How do I prepare?

- 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 readiness.
- Work with the supply chain to build resilience and agility.
- Understand sources of components and materials. Examine the possibility of using alternative providers.

Review delivery strategy

What is going to happen?

- Impact of downturn - tender pricing decisions influenced by the wider economic context.
- Additional customs check and potential COVID-19 disruption may cause near-term delays to materials/component deliveries.
- Key events can trigger foreign exchange fluctuations.
- Excessive risk transfer related to a combination of COVID-19 and Brexit can limit the available contractor pool.

How do I prepare?

- Understand how the critical path may be at risk from unexpected customs delays and supply shortages.
- 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 and COVID-19 risks.

Review risk transfer mechanisms

What is going to happen?

- Complex commercial environment – Brexit-related disruption could become mixed with other claims.
- Disruptive working caused by COVID-19
- Fragile supply chain.

How do I prepare?

- Check that records are sufficient to allocate responsibility for disruption.
- 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; how is the Brexit disruption risk allocated between the main contractor and the supply chain?
- Identify contractual exit points.

Undertake due diligence

What is going to happen?

- High levels of financial fragility remain in the supply chain, including the impact of additional COVID-19 costs and loss of revenues.
- Supply chain is exposed to Brexit and COVID-19-related financial risks.
- Professional indemnity insurance and performance bonds are harder to obtain.
- Insolvencies are rising.

How do I prepare?

- Commission a comprehensive review of current financial and deliverability status.
- Review contingent liabilities.
- Prepare contingency plans...
- Check extent and resilience of insurance cover.

Make contingency plans

What is going to happen?

- Costs may escalate.
- Labour supply may be affected by the end of free movement.
- Imports of EU materials may be more costly.
- Disruption to logistics and programme.

How do I prepare?

- Organise contingency funds against identified risk areas.
- Review schedule and deliverability to develop contingency plans.

Spotlight on: Innovation in construction

Innovation in the construction industry will always be challenging; the sector operates on significantly smaller profit margins than most industries, a high proportion of SMEs results in fragmentation, and there is a perception that construction can be conservative and slow to move.

Sometimes this perception is challenged by innovation supernovas like the technology-focused offsite construction company Katerra, but even then, there can be a struggle to sustain new business models. Yet against all the odds, construction innovation in the UK has seen a real boost in the past two years, driven primarily by the Construction Sector Deal.

The Construction Innovation Hub was created in 2018 with £72 million funding from the UK Research and Innovation's (UKRI) Industrial Strategy Challenge Fund. For the last two years, it has been busy facilitating the development and implementation of new technologies such as construction platforms, coordinating knowledge transfer across multiple sectors and partners, and managing three R&D programmes funded by UKRI.

These programmes include research and development focused on productivity, performance, and quality, as well as a specific focus on Modern Methods of Construction, digital, and whole-life performance. There is also a large-scale demonstrator programme for near-market technologies. In total between 2018 and 2020, 55 projects have been awarded £48 million in grants, and have raised at least £36 million in match-funding from research consortia. Importantly, the timing of the programme – aligned to planned government investment - reflects a strategic approach to construction transformation.

Close to market - demonstrator projects

The demonstrator projects, focused on the large-scale application of technologies in a real-life setting, all focus on implementing a transformative approach to the way we design, build and manage the construction process. They use product-based design solutions, with emphasis on design for manufacture and assembly, modular construction, and automation.

These methods will be validated on a range of developments, such as commercial offices, a building on an industrial park and affordable housing sites. Attention is given both to standardisation of the construction elements and operations. For example, Mace and 3D Repo are working with Imperial College London and University College London on the implementation of the AEC Production Control Room, which will provide repeatable construction management and reporting tools.

Emerging ideas

The R&D projects, on the other hand, explore technologies and solutions that offer the potential to enhance and improve design and construction methods – such as a 3D printing system for pre-manufacturing of primary structures, or a digital solution to facilitate the sale and distribution of surplus wet-concrete in real-time to reduce carbon emissions. However, some of these solutions will only be applicable once the challenges addressed by the demonstrator projects are resolved. For example, using artificial intelligence and robotics to extract information about building components and feed it into 3D printers requires a platform approach to be developed first.

The future is a platform

The Construction Innovation Hub has focused a lot of attention on the development of a platform approach to construction. The platform revolution is already well underway, supported by the Government 'presumption in favour of offsite construction', which came into effect in 2019. A successful adoption of the platform approach and subsequent innovative technologies will contribute to addressing the long-standing issues of productivity, enabling faster delivery, and also minimising the carbon impact of the construction sector.

In the longer term, it could also help transform the industry's image into a high-tech manufacturing-based sector and attract new, diverse talent. While both demonstrator and R&D projects are still ongoing, anyone who wants to contribute to sector transformation should follow three simple steps:

1. **Inform yourself about ongoing initiatives**
2. **Consider their impact on your business**
3. **Spread the word with clients and the supply chain.**

These actions will create a 'market pull', increase awareness of technology and help prepare the ground for its application. After all, knowing is half the battle.

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