ARCADIS

Running on empty

Introduction

Hopes for a construction recovery have gained momentum during 2024. However, anaemic economic growth forecasts, high levels of insolvency and a weak forward pipeline suggest that the construction market could continue to run on empty for much of this year.

Is the CPI target in reach?

The inflation outlook has changed dramatically in the past three months. The 2% Club refers to a group of economic forecasters who predict that the government's 2% target for the Consumer Prices Index (CPI) would be reached in early 2024. This is a huge change given the Bank of England (BoE) forecast in November 2023 that CPI would not fall below the target before the end of 2025.

The 2% case was strengthened by latest inflation data from the Office for National Statistics (ONS), showing that UK inflation remained steady at 4% in January 2024 – 0.75% below BoE's forecast. Stock markets jumped on the news, and traders now favour three quarter point interest rate cuts by the end of the year, starting in June. Long-term borrowing costs continue to fall, with the average cost of mortgages and commercial loans falling fractionally, according to latest BoE data.

The UK's descent into a technical recession in 2H2023 also prompted calls for early interest rate cuts, further boosting stock markets. However, BoE Governor Andrew Bailey played down the news, warning against putting "too much weight" on the figures as they were "very shallow". Indeed, February saw the BoE publish a marginal upgrade to its forecast for GDP growth in 2024 and 2025 to 0.25% and 0.75% respectively. BoE appear to have got their timing right, with the latest Flash PMI reading of UK services and manufacturing growth prospects for February beating expectations at 53.3, the highest reading since May 2023.

Whilst BoE have cut their short-term inflation outlook, they expect that CPI will rebound to around 2.75% by the end of this year and will remain above the 2% level for a further two years. A touch of caution makes sense, as UK services inflation nudged up to 6.5% in January. Sticky inflation is also evident in the US, where headline rates slowed by less than expected to 3.1% in January, impacted in part by rising wholesale prices, up by 0.3%. As a result of recent data, both the inflation outlook and expectations for the speed and scale of rate cuts remain uncertain.

Has the market overreacted to improved prospects?

Stock market performance in 4Q2023 has highlighted the expectation that cuts in interest rates will boost economic performance. Shares of housebuilders and property companies that have been hammered over the past couple of years have ridden a wave of rising prices alongside tech firms.

For construction, the improvement in sentiment first seen in December 2023 gathered further momentum in early 2024. Latest CIPS PMI data, for example, highlights the brightest 12-month business activity expectations for two years, even though construction output was described as declining for the fifth month in a row.

This response makes perfect sense in housing, where expectations have been pared back so much over the past 18 months. Recent trading updates from the major housebuilders included Persimmon reporting a 'strong improvement' in sales at end of 2023, while Taylor Wimpey mentioned 'good levels of enquiries so far this year'. In practice, annual sales in 2023 fell by 33% and 23% respectively and recovery will be a slow process. Meanwhile, property website Rightmove reported that volumes of housing sales in the UK were up 16% in the first six weeks of 2024. Such data helps to explain why listed housebuilders have seen their share prices rise by between 13% and 21% in the last three months, compared to 3% for the FTSE 100.

Commercial property also saw a positive, albeit marginal uptick in total return by 0.1% in January 2024, according to CBRE, led by an improved performance by the retail and industrial segments. Offices are still shedding value, but many investors believe that the bottom of the market is close.

The counterfactual to rising share prices is evidence that construction sectors are still struggling to grow. National Housebuilding Council (NHBC) data, for example, highlights that only 105,449 new homes were registered in 2023, 44% down on levels seen in 2022. Such findings help to explain why the Construction Products Association (CPA) downgraded prospects for 2024 in its January forecast, suggesting UK construction output would fall by 2.1% this year, driven by a further 4% fall in the private housing sector.

Elsewhere, the risk from supply chain failure continues to grow. Government data shows there were 4,370 construction insolvencies in 2023, 4% up on 2022 and 45% above the long-term trend since 2010. More could follow, with insolvency specialist Begbies Traynor reporting over 83,000 construction firms were in significant financial distress at the end of 2023, while the numbers in 'critical' financial distress – often a precursor to formal insolvency – jumped by a third in the last quarter of the year to 8,000. At the same time, a range of construction players, from Watkins Jones and Laing O'Rourke to Lendlease and McLaughlin & Harvey, have all reported pre-tax losses in their latest accounts.

Weak construction data dents hopes for a turnaround.

Paradoxically, and despite all of the gloom in 2023, latest construction data from the ONS reveals that total UK construction output increased by 2.0% in 2023. This was the third consecutive year of growth – a remarkable achievement given the turmoil that clients and their teams have faced. Notably, all growth in 2023 came from a rise in repair and maintenance work, up 8.3%, as new work decreased 2.1%. However, growth petered out towards the end of the year. New build work contracted by 5% in 4Q 2023, driven by 7-8% declines in infrastructure and private housing.

Weak recent new orders data highlights that many contractors and sub-contractors face an uncertain 2024 as the market slows further. New orders recorded by ONS in 4Q2023 totalled £15bn, the lowest in real terms since 2Q2020, when the market crashed amid the chaos of the first Covid lockdown. Based on volume, orders fell by 13% in the quarter and by 21% year on year. The only sector that recorded growth was the tiny social housing sector.

The clear message is that any improvement to sentiment will take time to feed into the market. Although volume housebuilding could pick up quickly if demand returns, the weak state of the wider construction pipeline suggests 2024 will be much tougher than lead indicators like the PMI data suggests, with builders facing a slump in workload before new orders can be secured.

What might trigger a recovery?

Aside from falling interest rates, and with it the lower cost of borrowing, what other metrics might help a recovery for construction?

The growth in investment in energy transition is an obvious candidate, given the priority given to net zero by many stakeholders.

Progress is behind schedule. The investment delivery forum of the Association of British Insurers (ABI) has recently reported that the UK needs to invest more than £1.3tn to meet its energy, transport and housing infrastructure needs by 2030. However, we are currently £615bn short of the target. ABI cites a lack of investable projects as a key barrier. As such, the Forum has recently called for new public-private partnerships to help funnel £100bn of promised investment into green infrastructure projects such as energy networks.

As we highlight in our 'Zoom into' the UK's Infrastructure and Construction Pipeline, the Infrastructure and Projects Authority's publication will provide industry with greater certainty, allowing contractors to plan and invest for their target programmes. However, plans beyond 24/25 are at an early stage, government spending is currently projected to fall substantially over the next five years and any newly-elected government may change its priorities and delivery mechanisms.

In conclusion, while there is some evidence to suggest that an upturn in fortunes is on the cards, the uncertainty caused by an election year together with weak new orders data means that clients and contractors are likely to be running on empty for some time to come.

Forecast

2023 closed on a disappointing note, with the UK in a technical recession, falling site activity and a deep contraction in orders. However, with lower inflation baked-in and falling interest rates on the way, recovery should commence later in the year. Can construction respond to this uptick, or will other factors hold some sectors back?

In this section, as we highlight in our analysis of new work, the slowdown has become more widespread. In our commentary on restarting the cycle, we focus on new headwinds that could slow down a nascent recovery. Finally, we look at mixed fortunes in the infrastructure sector that points to an emerging capacity crunch for networks including water and power transmission.

Improvement in sentiment but new work thin on the ground.

Our Spring 2024 forecast was compiled just after a shallow UK recession. Based on latest data, construction's slowdown was both less severe and less broadly based than had been forecast for 2023. This does not mean that pain has been avoided, more postponed into 2024 as projects on site have been delayed, and as the future pipeline contracts. Greater client confidence signifies long-term improvement, but our sector still has to work through the consequences of a weak forward pipeline, which has been on a downward trend for 5 quarters.

However, even as market conditions continue to favour clients, contractors and their supply chain are being very selective in their project pursuits and risk averse in their pricing strategies. Dismal order books are as likely to trigger contractor consolidation as they are to result in overly competitive bid pricing.

How quickly could the market recover?

There are plenty of early indicators of a potential turn in the cycle, but the shape of the forthcoming recovery remains uncertain. Contractors and sub-contractors are choosing to focus on a smaller number of market segments where they can succeed in terms of both their project winning and delivery. Construction markets are becoming more fragmented and as a result, clients have less leverage, even in a falling market. With less competition comes less downward pressure on prices, and potentially a resumption of above trend inflation.

Our updated forecast takes account of the expected divergence in future workload opportunities for road and rail compared to utilities and networks.

Some factors point to a rapid take-up in work once conditions improve. The growth of refurbishment work in the commercial sector for example will deliver a programme of work with a much shorter lead-in time than for traditional demolition-led, new build schemes. Furthermore, there are a large number of on-site residential schemes that have been mothballed pending an improvement in market conditions. Molior counted 65 stalled schemes in London alone during 4Q2023. When the market does turn, these could restart quickly – absorbing available capacity before projects in design get through procurement.

By contrast, there are some time-specific factors that indicate that recovery might be stalled:

- Elections. National, mayoral and local elections are due to take place in 2024 and will inevitably have an impact on the timing of funding and planning decisions. Purdah for the local and mayoral elections starts in March 2024. With funding tight, any change of political control is likely to result in a programme re-evaluation for public schemes which will trigger a further delay.
- Regulatory change. Regimes for biodiversity net gain (BNG) and building safety have progressed towards full implementation in early 2024. BNG will potentially act as a viability barrier, particularly if offsite mitigation is required, with the price of biodiversity units increasing to over £40,000 each. For Building Safety, reportedly only two schemes have been submitted so far for Gateway 2 review, so the large new project pipeline is very thin indeed. Now that the transition period is over, gateway requirements for higher-risk projects will slow procurement and approval processes by months.

In summary, even if the interest cutting cycle does start in H12024, it will take a considerable time for the benefits to trickle down to the construction supply chain. The window of opportunity for clients should remain open for a little longer yet.

Two speed recovery on the cards as water and energy take off.

Infrastructure spend and in particular public sector infrastructure investment has been the big winner over the past 5 years. Building back better focused rapid growth on transport infrastructure in particular, exemplified by HS2. Whilst expenditure on the energy sector has remained steady at a high level of around £15 billion per annum (2023 prices), road and rail spending has doubled to around £22 billion a year (2023 prices).

A real terms reduction in public infrastructure investment is on the cards, whatever the colour of the next government. The conservatives have inked in a freeze in capital spending levels at 2024/25 levels until FY28/29. Labour are similarly hemmed in by fiscal rules and with revised plans for capital investment focused on a National Wealth Fund and a new state net zero champion, Great British Energy.

The practical implications are that workload in the transport sector will taper off, particularly on smaller schemes as finance is channelled towards transformational investments such as HS2. By contrast, investment in networks will have accelerate beyond the already huge levels of investment seen on Hinkley Point and Offshore Wind. In water for example, Business Plans for AMP8, currently under evaluation by OFWAT, imply an increase in annual expenditure of between 50% and 120%, including mega schemes delivered under the Direct Procurement for Customers (DPC) such as Southern Water's Water for Life Programme. The transmission programme in the IPA pipeline for 2024/25 is worth £2.7bn alone and clients and their supply chains are struggling to secure scarce resources including HV cable against the backdrop of rising global demand. On some transmission projects, double-digit inflation is taking place, triggered mostly by rising costs of equipment and cable.

We anticipate a 'K' shaped inflation trend for infrastructure, with inflationary pressures diminishing in rail and road as workload eases off. Mega projects like HS2 will still face resource challenges, but smaller projects should become easier to deliver as capacity in tier 2 and tier 3 contractors increases. By contrast, we anticipate that networks including water and energy transmission and distribution will be most exposed to inflationary pressures.

Materials – structural deflation coming to a close.

Material prices have continued their downward trajectory, but not for much longer. Latest data from Department of Business and Trade (DBT) records that prices for a basket of materials for new build construction fell by 4% in the 12 months to December 2023, the lowest level of deflation recorded since May. Although there has been very little aggregate price movement in the past three months, some of the big price reductions seen during 2023 such as rebar will start to unwind during Spring 2024, and deflationary pressure will ease. The only notable increase recorded by DBT in the past quarter is concrete – up by about 4%.

Commodity prices continue to be stable and, in most cases, well down on prices from early 2023. Whilst iron ore prices nudged up by around 10% during 4Q2023, European natural gas prices have continued to fall and recently returned to low, long-term price levels last seen in May 2021.

Markets could have been disrupted by conflict in the Middle East, but so far this is not the case. Container costs have risen but these costs are marginal for light-side, non-bulky products such as electrical components, timber and board and small tools. Energy costs have remained stable or in the case of liquefied natural gas (LNG), have fallen to levels last seen in Autumn 2021. Distributors have sufficient inventory to deal with delivery delays. This means that, at least for now, the UK construction sector is insulated from the impacts of global conflict, and when material inflation does resume in late 2024, it will be very moderate.

Labour – signs of spare capacity.

National wage awards for all trades were concluded by October 2023. All two-year deals secured by mechanical, electrical and plumbing (MEP) trades feature increases of between 3-5% for the second year starting January 2025. These are a useful pointer for the 2024 building trades award, which will take effect in July 2024.

Indicators of spare capacity continue to highlight that demand for labour in the construction sector is weaker than the wider economy:

- Vacancy levels. Vacancy levels remain at their lowest level since Covid, with 2.3 vacancies for every 100 employed, well below the economy-wide average of 3.0.
- Average weekly earnings. Latest regular pay growth data for 4Q 2023 shows construction with the lowest growth of any sector at 3.7%. The average for the private sector was 6.2%

One of the causes of low pay growth in the sector will be spare capacity amongst self-employed operatives, who comprise around 35% of the workforce. Site rate inflation continues to be below the rate of the directly employed. Data from labour agency Hudson's Contracts records an average increase in weekly earnings of 2% since November 2022.

One labour cost watch out is the 9.6% increase in the national living wage taking effect in April 2024. Whilst this is unlikely to affect construction activities directly, there could be knock-on effects in the manufacturing and distribution sectors, particularly if further increases occur to preserve differentials. The national living wage is one of the reasons why CPI is expected to rise during 2H2024 to around 2.75%.

Forecast

Markets have continued to perform weakly as expected. Low volumes of orders recorded in Q42023 are consistent with our view that 2024 will mark the bottom of the cycle. As we highlight in our commentary on the speed of recovery, we see some significant headwinds affecting both the public sector and the residential sectors, even as market conditions improve. On this basis we maintain an unchanged forecast for buildings in London and Regional markets.

Our central case for the period 2023 to 2025 remains low inflation, not deflation.

For infrastructure we are amending our forecast, taking into account weakening demand for transport projects as well as parallel growth in networks serving both power and water. These inflationary pressures are related to demand and scarcity rather than sector specific background inflation drivers. The wider range from 2027 onwards reflects the 'K' shaped inflation trend discussed in our infrastructure focus.

For certain projects, particularly HV transmission schemes, inflation is likely to be in excess of the average figures set out in the table below.

	Regional Building Construction TPI	London Building Construction TPI	National Infrastructure Construction TPI
2023	2% (2%)	2% (3%)	5-7% (5-7%)
2024	1-2% (1-2%)	1-2% (1-2%)	3-6% (3-4%)
2025	3-4% (3-4%)	3-4% (3-4%)	3-7% (3-4%)
2026	4% (4%)	4% (4%)	4-7% (5%)
2027	4% (4%)	4% (4%)	3-7% (5%)
2028	4% (n/a)	4% (n/a)	3-8% (n/a)
Total	**18-22%**	**18-20%**	**21-42%**

Inflationary drivers	Deflationary drivers
• Continuing above-trend levels of workload in network infrastructure.	• Structural deflation from 3Q2023 onwards
• Supply chain consolidation	• General economic slowdown
• Attitude to risk transfer	• Order book replacement across most sectors
• Sector-specific demand for resources	• Attitude to work winning

Source: Arcadis

Spotlight on: regional hotspots

In this Spotlight, we update our analysis of regional data published by ONS to provide greater insight into dynamics affecting local markets. The analysis firstly seeks to understand which regions have seen a material change in workload by comparing average levels of output and orders (pipeline) for the period 2022 to 2023 with the long-term trend for the period back to 1Q2015. An extra dimension looks at whether growth across all of 2023 was up or down compared to the previous year.

From a workload perspective, the strongest regional markets are the North East, Yorkshire and the Humber, London and Wales. The North East and Yorkshire and the Humber regions continue to benefit from strong infrastructure workload as well as a substantial increase in demand from industrial clients. Wales is also seeing expansion in these sectors after a period of relatively low activity. The South East continues to be a soft spot with low workload in the commercial and public non-residential sectors. Scotland has seen an even bigger reduction in activity with only industrial seeing any growth at all. Commercial workload continues to be the weakest subsector, down by 19% compared to the long-term trend, with the public non-housing sector also disappointing at 11% down.

The shift in short-term performance is very marked. In Spring 2023, only Scotland saw a year-on-year contraction. By contrast, only five regions saw short-term growth over the past 12 months with the relatively small markets of North East and Wales performing best. Infrastructure was the swing factor in Wales, whilst industrial and commercial work picked up in the North East. The worst performing market was eastern England, down 15% year on year in real terms, with the housing, industrial and commercial sectors all seeing double-digit declines.

From an orders perspective, the picture is particularly grim. 12 months ago, 6 regions were seeing above-trend growth. In 1Q2024, all but two are lagging their long-term trend. North East and South West continue to do well. In both regions, growth in industrial and

infrastructure has compensated for a lacklustre housing sector. The worst performers are the East and West Midlands, with both infrastructure and housing orders well below the long-term trend. The greatest concern should be the analysis of year-on-year change, with all but 2 regions seeing a reduction in excess of 10%. Five regions including London and the South East have seen orders falling at a rate of over 20% in the past year compared to 2022, with infrastructure and industrial orders falling faster than housing in the London region.

Combining all the data, for 2024, the North East and Yorkshire and the Humber appear to have good current levels of workload and relatively resilient order books. The South-West continues to absorb relatively high levels of orders that have increased at double digit rates for two years. The West Midlands and Eastern England have seen two successive years of declining order values that may open a window of opportunity as contractors take further action to secure workload. Overall, the weakest market in the survey is Scotland, where workload continues to decline against the long-term trend at an accelerating pace and where growth in orders went into reverse in 2023.

Annual change in workload and new orders, constant prices, 2023

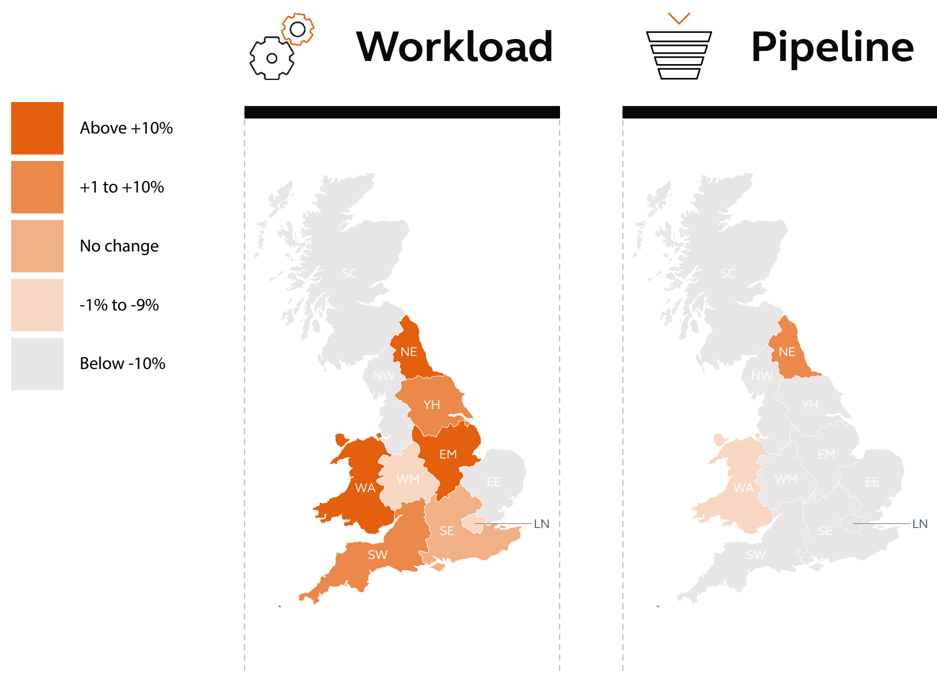
	Workload	Pipeline
North East	**+11%** (++)	**+20%** (-)
North West	**+2%** (--)	**-8%** (--)
Yorkshire and the Humber	**+14%** (+)	**-2%** (--)
East Midlands	**+2%** (++)	**-10%** (--)
West Midlands	**+4%** (-)	**-10%** (--)
Eastern	**+1%** (--)	**-8%** (--)
London	**+8%** (-)	**-5%** (--)
South East	**-5%** (=)	**-2%** (--)
South West	**0%** (+)	**+14%** (--)
Wales	**+13%** (++)	**-8%** (-)
Scotland	**-15%** (--)	**-6%** (--)

Explanation of the table:

Data in bold is represents the trend rate for workload and orders in comparing the average level in 2022 and 2023 with the long-term average for the period 2015 to 2023.

Data in brackets is short-term movement of workload and workforce based on full year-on-year change between 2022 and 2023. (=) is no movement. (+) and (-) is movement less than +/-10%. (++) and (--) is movement greater than +/-10%.

Data is sourced from ONS: Construction New Orders Table 6 and Sub-national Construction Output Table 1. New Orders and Output data is deflated to constant prices.



Zoom into: the IPA Pipeline – will it make a difference

February saw the publication of the much-delayed National Infrastructure and Construction Pipeline 2023. Our Zoom into feature looks at key aspects of the pipeline, how it has changed, and whether it will turn the dial up on infrastructure sector spend.

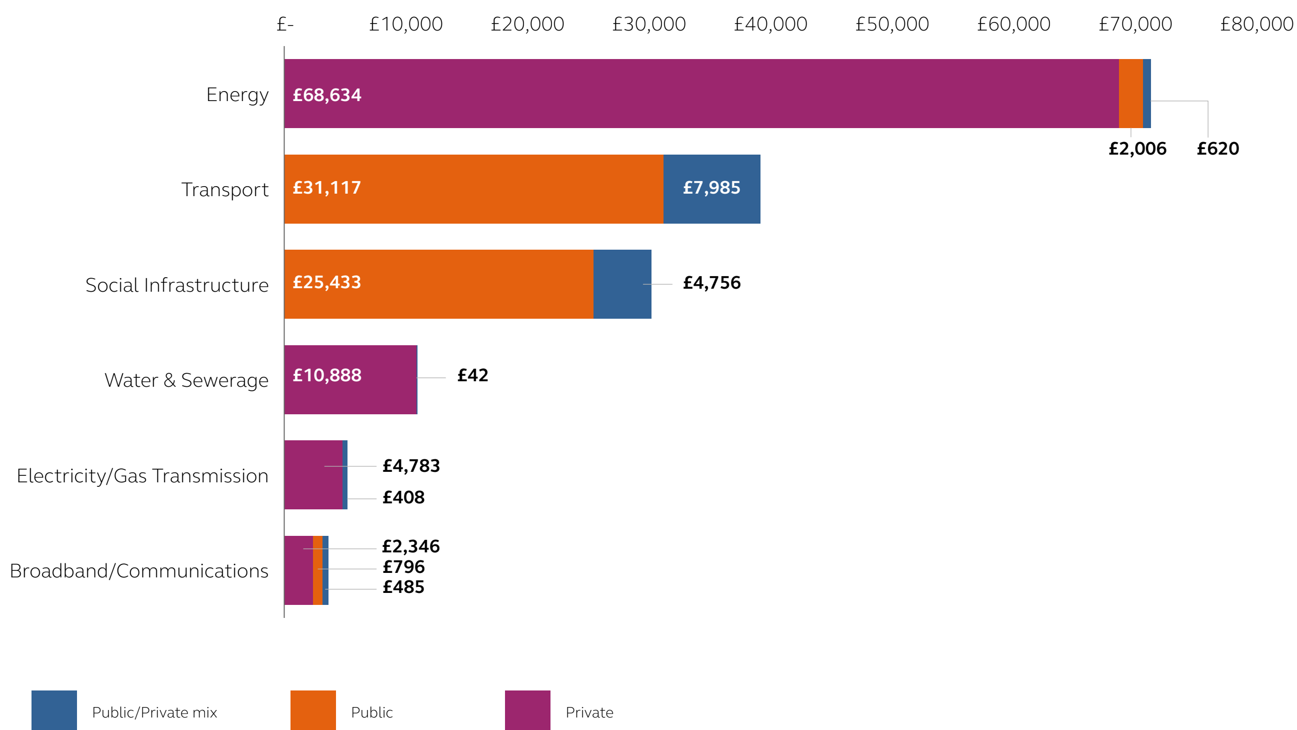
What is the IPA Pipeline?

The National Infrastructure and Construction Pipeline (NICP) is a bi-annual report published by the Infrastructure and Projects Authority (IPA), providing a mid-term view of infrastructure spend. The Pipeline includes planned public and private investment, mainly in England up to March 2025, together with a string of programmes that could begin during the next 10 years. In practice, much of the profiled spend is notional. There is also a procurement programme, describing £35 billion of spend, albeit that most of these appear to be closed rather than future opportunities.

The 2023 Pipeline outlines 660 planned and potential projects worth in total between £700 and £775 billion. In real terms, this is broadly equivalent to the value of the previous (2021) pipeline. Just over half of the planned pipeline to 2024/25, worth around £85 billion, is privately financed, with 80% of value focused on energy generation. Looking beyond 2025, as public spending falls, an even greater proportion of the schemes are likely to be reliant on private investment.

Of the £379bn of planned investment, £164bn (43%) is shown as occurring in the first two years of the pipeline, with a further, more indicative £215bn spend to 2032/33. A very large proportion of the initial spend is focused on energy generation and describes some programmes that have been in flight for many years. Given delays due to planning and viability issues and other factors, the anticipated level of spend up to 2025 may not be achieved. Conversely, many more programmes will join the forward pipeline as the energy transition accelerates and as programmes such as the £96 billion AMP8 water are approved.

Chart 1: *Funding mix of planned investment in the pipeline from 2023/24 to 2024/25 by sector (£m)*



Source: National Infrastructure and Construction Pipeline 2023, IPA, February 2024

Pipeline Comparisons 2021 v 2023

The table compares the two latest editions of the IPA pipeline. Whilst the value of the pipeline has increased, it will have taken into account substantial inflation since 2021. The main change is that the value of public programmes with MMC potential has reduced over the period.

	2021	2023
Project numbers	528 programmes worth £650 billion	660 programmes worth c.£700-£775 billion
Future workforce requirement	Annual average of 425,000 workers needed for delivery	Annual average of 543-600,000 workers required, of which 60% are construction jobs.
Public or Private	Private: 115 schemes accounting for c.50% of planned investment Public: 418 public sector programmes, representing c.50%	54% of the planned pipeline to 2024/25 is funded privately
Modern Methods of Construction (MMC)	143 projects with MMC potential, representing £79bn of total investment	£64bn of planned investment to FY 24/25 with some MMC potential.

Sub-sector summary

Transport investment is projected to reach £234bn over the pipeline's ten-year period. Projects cited include Network North – the £36bn package of transport upgrades announced to redirect HS2 money, together with an expansion of Northern Powerhouse Rail, a mass-transit system in West Yorkshire and £9bn of regional funding through the City Region Sustainable Transport Settlement.

Unsurprisingly however, given the targets for energy transition and net zero, it is the energy sector which is predicted to receive the largest share of investment, with around £316bn projected over the next 10 years, including spend on Hinkley Point C, as well as nuclear decommissioning work. Sizewell C is not yet identified as a separate programme.

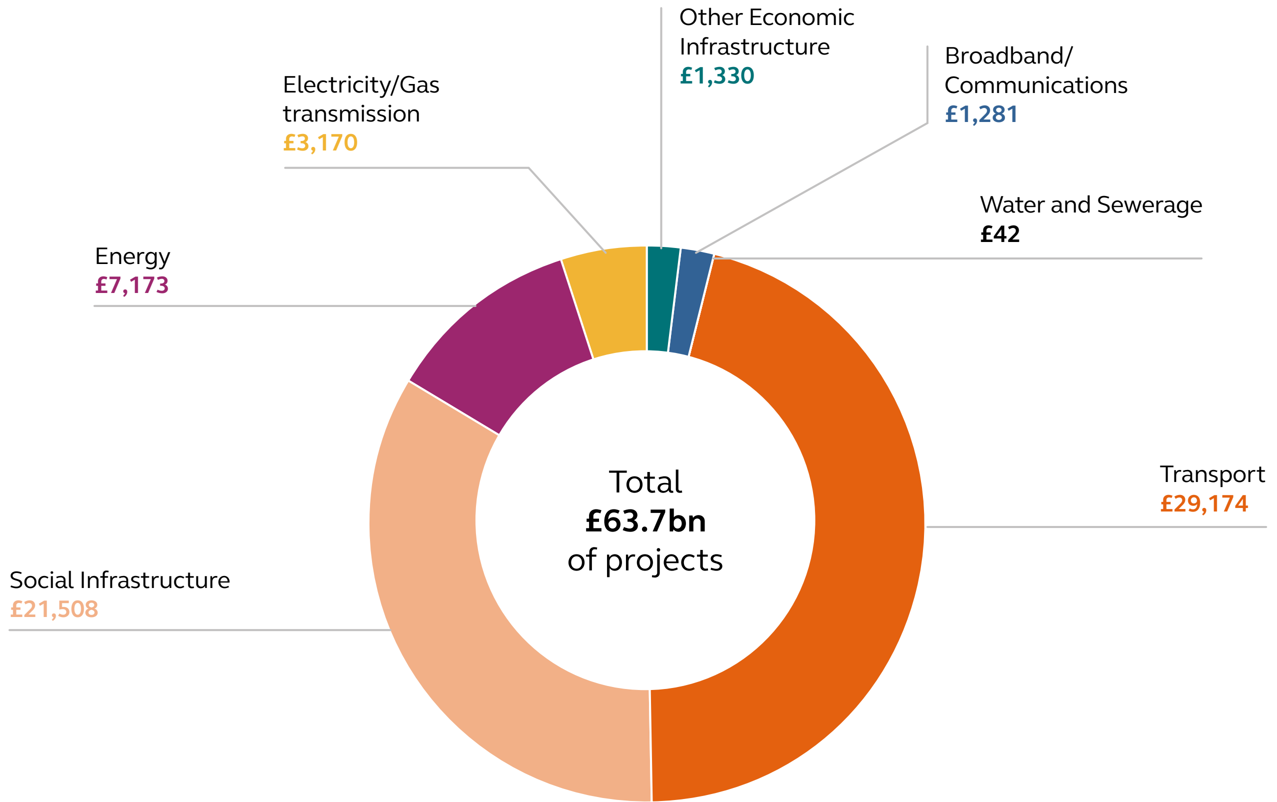
Notable, too, is a big uptick in electricity and gas network spend, with £78bn of such schemes planned between now and 2032/33 as electrification investments grow in pace.

Continuing opportunities for MMC.

While the use of modern methods of construction (MMC) has suffered in the housing sector in the last 18 months as output has fallen, infrastructure appears to provide future opportunity, guided by the Transforming Infrastructure Performance (TIP) Roadmap to 2030. The recently completed HMP Fosse Way scheme included a reported 70% uptake of MMC solutions.

The 2023 pipeline highlights programmes worth £64bn up to FY24/25 that could be delivered with elements of MMC, with £29.2bn in transport (46%) and £21.5bn in social infrastructure (35%) representing most of that spend. No analysis of private sector spend is available. Given recent criticism by the House of Lords Built Environment Committee on government's failure to have a clear investment strategy, it appears that project sponsors will need to work harder to develop these opportunities for MMC.

Use of MMC in Planned Investment in the Pipeline from 2023/24 to 2024/25 – by sector total (£m)



Source: National Infrastructure and Construction Pipeline 2023, IPA, February 2024

Is the pipeline deliverable?

Whilst the clarity provided by the pipeline is helpful, there are many variables which will inevitably impact delivery over the suggested timescales, even in the year between now and the end of the FY24/25. The IPA's report highlights continuing challenges, including affordability, planning delays and skills shortages. Reduced investor confidence in the UK could be a problem also.

In practice, there are genuine constraints on the ability of the IPA to provide clarity to the construction supply chain beyond 2025. Granular detail of the schools investment programme or the Environment Agency's flood prevention programme, for example, is useful but is most likely already available to contractors on the relevant frameworks. Most future spend beyond FY24/25 will not be determined until a Spending Review is completed, and as a result, cannot be shown. Long-term spending commitments by government remain the exception rather than the norm. Investment in the energy generation sector is modelled rather than based on projects and even mega schemes including Sizewell C can't be included until a Final Investment Decision is taken. Ultimately, for the all-important private investment, certainty will come from decisions made in company boardrooms rather than from the IPA's impressive and detailed analysis.

As a result, and in practice, the IPA's pipeline provides little additional long-term certainty beyond the current spending review envelope to 2024/25.

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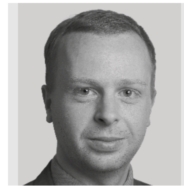

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Arcadis

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