Market View
Spring 2023

Clinging on

Introduction

Prospects for the UK economy have improved markedly since the start of 2023, with inflation falling more sharply than expected and growing expectations that headline interest rates could be near their peak. However, even though 2022 proved to be a good year for construction, demand is still expected to fall sharply in 2023. For now, construction is clinging on to any workload that can be secured in a deteriorating market.

A less negative outlook…

Even though GDP grew by only 0.2% in the second half of 2022, the mere fact that the UK dodged a recession helped a turnaround in sentiment and prospects.

As the table below shows, whilst the latest forecast from the Bank of England (BoE) is grim, it is much less dire than the bleak outlook forecast in November. The BoE is now anticipating a shorter, sharper contraction in GDP growth in 2023. Meanwhile, Chancellor Hunt received a £30bn 'windfall' in February 2023, due to higher-than-expected tax revenues, reduced borrowing by local authorities and lower than planned subsidies for household energy bills.

February inflation forecasts from Citigroup were quite bullish, suggesting CPI will fall to below 5% by July 2023 and to just 2.3% by November. Most of the improvement is driven by global rather than UK factors – particularly a significant easing in energy pricing pressures.

	BoE Nov 2022 Forecast	OBR Nov 2022 Forecast	BoE Feb 2023 Forecast
GDP	2023: -1.5% 2024: -1.0%	2023: – 1.4% 2024: +1.3%	2023: -0.5% 2024: -0.25%
CPI	Year to June 2023: +9.5% Year to Dec 2023: +5.2%	Year to Dec 2023: +7.4%	Year to June 2023: +8.5% Year to Dec 2023: +3.9%
Base Interest Rate	Peak of 5.25% in Q2 2023	Peak of 5% in mid-2023	Peak at 4 – 4.5% in 2023
Unemployment	Q4 2023: 4.9% Peak of 6.4% in 2025	Peak of 4.9% in Q4 2024	1Q 2023: 3.7%. Peak of 5.3% in 1Q 2026
Business Investment	Year to 4Q 2023: -3.5% Year to 4Q 2024: -6.5%	n/a	Year to 4Q 2023: -5.5% Year to 4Q 2024: -5.75%

Nevertheless, when we describe an improvement in UK prospects in 2023, we are still describing matters getting less worse rather than much better. As if to illustrate this, the BoE's latest outlook contradicts the Office for Budget Responsibility's (OBR) cheery 2024 growth forecast. Latest business investment projections are also disappointing given that current levels are 8% below the pre-pandemic baseline.

Poor investment prospects together with a stubbornly tight labour market, are the key reasons why the BoE now believe that Britain's economy will not be able to grow at a rate above 1% without the risk of higher inflation. Previously, in the ten years before Covid, the sustainable growth threshold averaged 1.7%. The new lower threshold implies that it will be very difficult to increase earnings and the tax base in the medium term. Indeed, the BoE predicts that real terms UK GDP will still lag pre-pandemic levels in 2026.

For the construction sector, contradictory data suggest high levels of uncertainty. On the one hand, Glenigan data paints a picture of slowing demand, with the number of project starts falling by 47% in the three months to end January 2023.

Arcadis internal survey evidence also reveals examples of projects being delayed by a range of factors, with reducing scope, business case re-evaluation and reprogramming all featuring regularly.

By contrast, the March 2023 CIPS PMI reported an overall score of 54.6, up sharply from 48.4 in February. Any score above 50 is an improvement. The result is the most positive outlook in nine months, with a strong rebound in commercial work offsetting a drop in housing activity. However, looking further ahead, the RIBA Future Trends index points to further weakness in the pipeline with nearly a third of practices expecting workloads to decrease in the next three months. Again, this contrasts with the CIPS PMI which showed optimism rising sharply since December 2022. Even the outlook of the battered consumer improved, with the February GfK Consumer Confidence Index recording the best result since April 2022. That said, the overall score of -38 is very low and is a long way off pre-lockdown levels.

House building the main casualty in 2023?

The January 2023 RICS Housing Market Survey reports a further deterioration in housing market sentiment, with negative readings for buyer enquiries (-47%), new listings (-14%), completed sales (-39%) and house prices (-47%). This is the ninth successive negative monthly reading for new buyer enquiries. The downbeat mood is likely to persist for a while longer as the market adjusts to higher interest rates and the end of Help to Buy.

The survey backs up the most recent Construction Products Authority (CPA) forecast, which suggests housing output will fall by about 11% in 2023 as interest rates and affordability issues start to bite. Given that housing accounts for about 40% of new-build output, such a contraction will have a substantial impact on material and labour supply chains. As highlighted in the forecast, the housing market has remained resilient, with for example some big schemes in the North-West being triggered in 4Q2023.

Indeed, early 2023 trading updates from house builders suggested improved confidence, with conditions 'better than anticipated' and the market 'finding a new level'. However, a slowdown in new build housing remains the most likely scenario in the coming months, with the latest trading updates from Persimmon and Taylor Wimpey indicating a worst-case scenario of housing completions down 30-40% from normal levels.

Introduction

CPA doubles down on construction dip

The latest forecast from the CPA projects a reduction of total construction output of 4.7% in 2023. Compared to an economy-wide contraction of 0.5%, this will be a deep correction. Aside from the Covid-driven contraction in 2020, the sector has seen almost unbroken growth in the decade since 2012. Trying to predict the wider effects of the slowdown is currently difficult due to the resilience of markets in 2H 2022.

However, in addition to housing, there are other sectors where a contraction could accelerate. For instance, the industrial sector is likely to be past its peak, following stellar 25% growth since 2020. Amazon has recently announced plans to close three warehouses in the UK, while specialist developer Segro said rising interest rates had pushed up borrowing costs and depressed leasing demand. This resulted in a 15+% decline in the value of UK assets held by Segro and Tritax Big Box in 2022.

By contrast, aside from the infrastructure sector, where long-term investment programmes should see some further growth, there will be other sources of expansion in 2023. In the public sector, a second round of Levelling up Fund awards, totalling £2bn, was finally announced. A further £1.1bn is yet to be distributed. All £4.8 billion must be spent by April 2025, and so far, less than £300m has been paid out. The slow start means that public non-residential spending should increase quite rapidly during 2023, but not by enough to offset falls elsewhere.

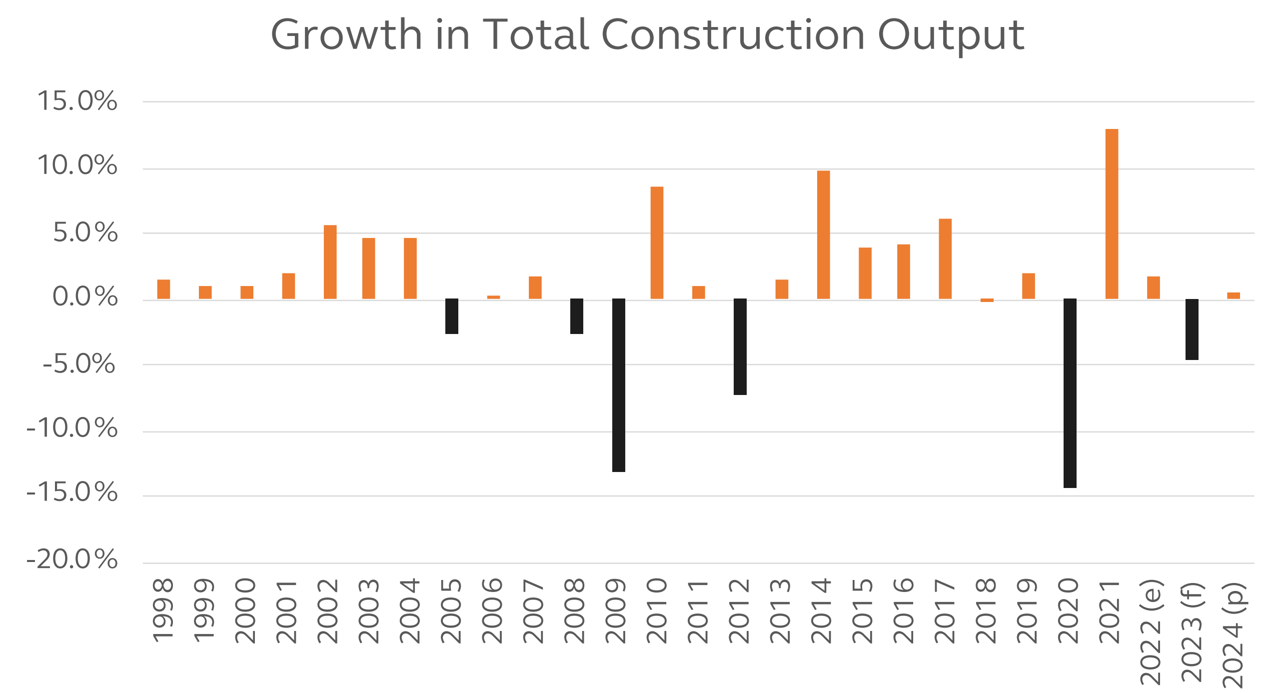
Tipping Point Factors

Early 2023 is a pivotal moment for UK construction and the wider economy. Poor policy decisions by BoE and the government could condemn the UK to a 'hard landing' and a deeper slowdown. By contrast, for construction, the current positive mood could result in a faster bounce back in workload. The table on p5 shows a range of factors which could influence the direction of travel from here.

The labour market, for instance, is expected to remain relatively tight over the next few quarters, with the potential to keep inflation higher for longer. However, both BoE and OBR forecast that UK unemployment will rise substantially from current levels of 3.5% to peak at between 5 and 6% in 2024.

What is clear is that the 'tipping point' scenario that accompanied our Winter 2022 forecast is yet to materialise, with ONS data on output and new orders remaining resilient through to the end of 2022.

Given that there has not yet been an emphatic reversal in actual workload, there is a downside risk that construction inflation could be more persistent for longer if demand levels remain healthier than expected.



Source: Construction Products Association. Winter 2022/23 Forecast.

	Positives	Negatives
Economy	• Faster reduction in inflation and interest rates. • Improved sentiment leads to increased investment. • Lower unemployment than forecast. • Budget is growth and investment positive.	• Investment levels lower than forecast. • High interest rates trigger hard landing. • Energy price volatility causes higher inflation.
Construction Sector	• Workforce growth and productivity improvements. • Lower energy prices result in less material cost inflation. • Faster throughput of levelling up projects.	• Cuts in public sector capital budgets • Planning – delays triggered by reforms to both housing and national projects. • Distressed debt affecting commercial and industrial schemes

Forecast

The UK's construction markets continued to be resilient throughout 2022. The sector delivered record output, even as the Ukraine War, soaring interest rates and the UK's chaotic political scene undermined investor confidence. How long can this winning streak continue in the face of significant headwinds?

More resilient, for now.

UK construction firms defied a very pessimistic outlook to post record levels of output in 2022. The size of the workforce also increased marginally in the 4th quarter, easing fears of an acceleration of the sector's own great resignation. Most importantly, the sector's new work pipeline continued to be boosted right until the end of the year, with 4th quarter orders down by only 1.8% and well above the long-term trend. Even the beleaguered housing sector did well, posting the best order intake in a year.

This good news story has developed against the backdrop of pessimistic forecasts from many bodies including the Bank of England and OBR. Ultimately the UK avoided recession in 4th quarter 2022, and with energy prices falling to levels not seen in eighteen months, tentative signs of animal spirits emerged, with the FTSE 100 index up by 5% since the beginning of the year.

Despite headwinds, particularly from external inflation drivers, many sectors including new build housing, infrastructure, industrial and all repair and maintenance (R&M) hit near record levels of activity. R&M output in 2022 was 11% above pre-pandemic levels. This creates a lot of headroom with respect to capacity, but also a big cliff edge in connection with continuing workload. Logistics workload in particular looks vulnerable in the short-term as investors take fright. According to Colliers, industrial land values dipped by 47% in H2 2022, highlighting a sudden tightening in the development market.

Looking in more detail at the output data for Q4 2022, the early signs of market challenges are plain to see, but perhaps not emerging as quickly as expected. The sectors that grew most strongly in 2022, including new building housing, industrial and housing R&M all saw activity falling in the final quarter. Furthermore, market fundamentals for each of these sectors remain poor despite the improved 2023 outlook. Housebuilder expectations around starts are cautious, logistics valuations fell sharply during 4th quarter 2022 with yields rising by around 150 bps, and GfK continue to report a historically low score for consumer confidence associated with big spending decisions. This leading data gives plenty of credence to the CPA forecast for a 4.7% fall in output in 2023. The slowdown anticipated since last Spring might have been delayed, but it is still coming down the tracks.

Record year beats expectations but workload risks loom.

2022 was always on track to be a good year for the construction sector, but it turned out to be a record breaker, with output in cash terms exceeding £200 billion for the first time. A combination of the V-shaped recovery, strong housing market and a booming R&M segment were setting the industry nicely prior to a second inflation crisis that hit shortly after the Ukraine invasion in February 2022. However, even with eye-watering price rises accounted for, workload grew much faster than expected. Looking back at the CPA's Winter 2021/22 forecast, new work was expected to grow by over 5%, with repair and maintenance barely growing by 2%. Whilst new build fell slightly short, the R&M sector grew rapidly across housing and non-housing categories, ultimately adding an extra £5 billion to industry turnover. R&M is labour intensive, so it is not surprising that labour market concerns persisted throughout the year.

Orders for new work exceeded £80 billion in cash terms for the first time, but when adjusted for inflation were up by barely 1%. This means that order books are not being fully replenished. The distribution of new work is of course very important and here it is clear that the public sector has taken the lead, with infrastructure and public housing and non-residential all showing healthy growth in some regions. For example, the South West and Wales have seen a big boost in new opportunities in the public sector whilst previously red-hot locations including the West Midlands and Yorkshire and Humberside have been much more exposed to a slowdown in housing markets. As a result, there is likely to be a much greater variation in market conditions across the regions in 2023 and beyond and a good chance that contractors in many markets will be focused on rebuilding the pipeline during 2023. Our examination of regional trends in the Spotlight feature highlights growth areas and regions with a greater risk of slowdown.

Industry forecasters including Arcadis have been taken by surprise by how resilient the forward pipeline has remained. Clients and their project teams have faced headwinds throughout the year, but overall demand has not flagged.

Our updated view however is that market fundamentals have not changed and that current levels of demand cannot be sustained. Business and consumer confidence has improved marginally but is still weak. Furthermore, even as the Bank of England upgraded its recession forecast for 2023, it downgraded its assumption of long-term sustainable growth. Our "Zoom into….the impact of higher finance costs" highlights the size of the markets that are exposed to this long-term shift. Big markets like the private housing sector will come under progressive pressure as more borrowers take on more expensive debt. Similarly, with Real Estate having the greatest exposure to debt impairment, the ability of developers to bring schemes forward will be held back by both viability issues and lenders' greater sensitivity to risk.

Whilst there remains little official data to evidence a slowdown, there are plenty of warning signs. Our revised view is that markets will have started to soften by the end of 1H 2023.

Forecast

Pay and productivity.

Two years ago, in our Spring 2021 Market View, we ran a special feature on labour productivity as part of our review of a window of opportunity in post-Covid markets. At the time, we highlighted early evidence of a 2% post-Covid increase in productivity in 2020. This was a good sign that the construction sector was using its skilled labour better, providing extra capacity to absorb growth.

As workload and inflationary pressures accelerated in 2022, our theory has been thoroughly tested. Overall, the labour force remained static at 2.16 million, even as real terms output increased. In headline terms, the implied productivity increase in the year is over 5%, which is a remarkable performance after years of flat or even negative productivity growth. Over 50% of output growth occurred in the repair and maintenance segment, and it is possible that growth in the R&M workforce was under-measured. However, new build activity also grew briskly, enabling us to consider whether labour productivity is countering inflationary pressure.

Construction earnings are notoriously difficult to track due to high levels of self-employment. Lurid headlines in January 2023 described the £1,000 a week earnings of skilled self-employed workers recorded by payroll company, Hudson Contracts. However, average earnings were up by only 4.5% in the year, below the 5.3% recorded by ONS for directly employed construction operatives for the same period. In practice, construction wage inflation has been no higher than the wider economy. The data suggests that despite the booming workload, there has not been an inflationary premium for construction in 2022. This in turn is evidence for the positive impact of productivity gains.

Looking forward, our long-term inflation forecast assumes that the growth of the labour force will lag growth in output and demand, and labour scarcity will continue to be a problem. Latest CITB forecasts project the requirement for an additional 225,000 workers by 2027, highlighting the potential for a growing labour shortage. Continuing improvements in productivity will play an important role in reducing labour market pressure over the forecast period.

Beginning of the end for materials price inflation.

Sky high material prices have been the major factor driving inflation since the beginning of the V-shaped recovery in May 2021. Thankfully, there are now clear signs that the inflationary pressure is subsiding, even as some product categories such as thermal insulation see prices increasing very quickly. With wholesale energy prices lower than they were in Spring 2022, inflationary pressure will ease even if energy remains three times more expensive than the long-term trend.

The CLC's Product Availability Group's February update for example highlights that almost all supply constraints have been resolved. Materials price inflation as measured by the newly branded Department for Business and Trade is well below its peak of over 30% reached in June 2022. The rate subsided to 15% by December 2022 and is on track to fall to 5 or 6% by May this year. Pre-Covid, the long-term inflation trend was 4-5% so these are encouraging signs of a return to more normal trading conditions.

However, there are some downside risks, particularly related to commodity prices that are back on an upward trajectory after a soft 2022. Iron ore is up by 32% from a price trough in October 2022. Copper is up by 18%. Whilst price hikes are not expected to reach the peaks seen in 2021, the re-opening of Chinese real estate markets adds a further complicating factor. Whilst market signals are positive for 2023, contractors and their clients are going to need to stay alert with respect to short-term price fluctuations.

Forecast.

The economic outlook has improved markedly since we prepared our last forecast in November 2022. However, the headwinds that informed our view that markets would slow have not gone away. House builders have already adjusted to the new reality by slowing land acquisition, and the major infrastructure clients are reprofiling their investment programmes in line with inflated costs and fixed budgets.

The forecast now has three major components:

- Input cost inflation affecting labour and materials will continue to result in higher construction costs, even as workload falls.
- Regional differences in current and future workload will result in higher inflation in London compared to most regional building markets.
- Inflation trends affecting infrastructure and buildings will continue to diverge, with infrastructure being affected by materially higher inflation than for buildings.

On the demand side, the exact timing of a slowdown remains difficult to predict. However, a further reduction in input price pressures will help to mitigate inflation in H22023.

- We **increase** our 2023 forecast for buildings in London to 3%. This revision reflects the continuing resilience of the London market.
- We **retain** our 2023 forecast for buildings in regions at 2%. There are new hotspot regions including the South West and Eastern that will see significant workload growth in 2023 and 2024, and these could see price hikes above the regional average.
- We **retain** our 2023 forecast for infrastructure at 6 to 7% but acknowledge that total volumes of workload are set to fall from 23/24 onwards due to budget constraints and the effects of high inflation.
- We **retain** our buildings inflation forecast for 2024 and 2025 at 3% but anticipate that buying conditions could improve in 2024 if order volumes fall faster and further.
- We **retain** our infrastructure forecast for 2024 and 2025 at 3%. Falling conventional fuel costs will help to reduce input price pressure on many sites whilst lower levels of workload will also keep a cap on inflationary pressures.
- Looking forward to 2026 and 2027, we set out long-term inflation expectation at 5% across all sectors in recognition of likely long-term upward pressure on labour markets and earnings.

	Regional Building Construction TPI	London Building Construction TPI	National Infrastructure Construction TPI
2022	10% (10%)	10% (10%)	12% (12%)
2023	2% (2%)	3% (2%)	6-7% (6-7%)
2024	3% (3%)	3% (3%)	3% (3%)
2025	3% (3%)	3% (3%)	3% (3%)
2026	5% (5%)	5% (5%)	5% (5%)
2027	5% (n/a)	5% (n/a)	5% (n/a)
Total	**28%**	**29%**	**34-35%**

Inflationary drivers	Deflationary drivers
• Peak levels of workload	• Structural deflation after 2022 peak
• Legacy energy cost inflation	• General economic slowdown
• Core inflation	• Order book replacement in commercial and residential sectors
• Commodity markets	• Lower fuel costs
	• Risk attitude

Spotlight on: regional hotspots

The key finding in our Spring Market View is that despite substantial headwinds, markets have remained strong throughout 2022. With workload forecast to fall substantially in 2023 and with growth in orders for replacement work slowing, the regional distribution of existing work and new work will have an important bearing on future market conditions.

To provide greater regional insight, we have developed an extra analysis based on regional data published by ONS. The analysis firstly seeks to understand which regions have seen a sustained increase in workload by comparing average levels of output and orders (pipeline) for the period 2021 to 2022 with the average for the period back to 1Q2015. An extra dimension looks at whether growth across all of 2022 was up or down compared to the previous year.

In addition to workload and pipeline, we also examine workforce on a similar regional basis. The comparison is not quite like for like, because the workforce data is based on the location of the employer, not where the work is done. The data includes self-employed operatives.

From a workload perspective, it is perhaps not surprising that London and West Midlands feature strongly given the recent contribution to increased activity from HS2. The Eastern and Yorkshire and Humberside regions have also benefitted from strong infrastructure workload as well as a substantial expansion of industrial workload. The South East is surprisingly weak, due to a combination of a slowdown in the commercial and public non-residential workload. Wales has seen an even bigger reduction in activity affecting the same two sectors.

Commercial workload is the weakest subsector, down by 25% compared to the long-term trend. Even London's commercial workload is below par. On a short-term basis, most regions are up in the past 12 months which is little surprise given the strong end to 2022. Yorkshire saw an increase in workload across all sectors, whereas Scotland saw a substantial reduction in infrastructure and commercial workload.

From an orders perspective, the North East and South West have both done well. In both regions, growth in industrial and infrastructure has compensated for a lacklustre housing sector. London has a strong housing market but infrastructure orders in the past couple of years have not kept pace with some of the huge orders related to HS2 in 2017 and 2019. In practice this means that London continues to be a strong market. For Wales, the consequences of a moratorium on road investment and a static housing market contribute to a weak pipeline. However, Wales did benefit from a short-term boost in to orders in 2022 which also affected the South West.

Looking forward to 2023, the South West and Eastern Regions look to have the best long-term growth prospects. West Midlands and London look in good shape, but the volume of new replacement work is not keeping up. The weakest markets are East Midlands, Scotland, and Wales, mostly because of relatively low levels of activity in infrastructure and commercial sectors.

From a jobs perspective, only regions in the North of the UK including Scotland have seen a material increase. By contrast, London's workforce fell by 25% during Covid and is yet to recover. The workforce present in London is sourced from a much larger city region, so this finding does not necessarily suggest an immediate labour shortage. The substantial growth in the London workforce during 2022 suggests that the labour market has responded to growth in the UK's number one construction hot spot.

Combining all the data, for 2023, the South-West looks as if it could be a challenging market. The workforce seems to have contracted in line with the historic trend in workload, even as the pipeline strengthens. With few options available to expand the available workforce, a buoyant new projects market could be challenging in 2023. By contrast, the East Midlands, Wales, and Scotland which all saw sub-par levels of activity in 2021 and 2022 are likely to see a window of opportunity opening sooner than other regions in the UK.

Regional Hotspots (% change 2021 to 2022)

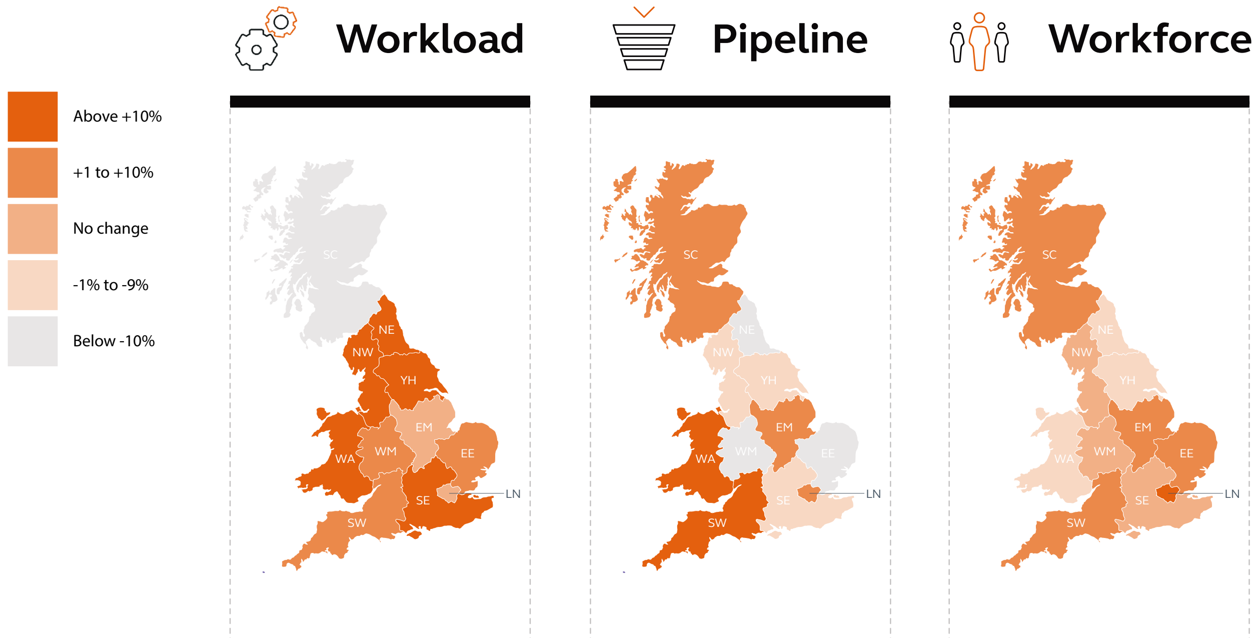
	Workload	Pipeline	Workforce
North East	-1% (++)	+24% (--)	+8% (-)
North West	+1% (++)	0% (-)	+8% (=)
Yorkshire and Humberside	+4% (++)	+4% (-)	+2% (-)
East Midlands	-6% (=)	-5% (+)	-3% (+)
West Midlands	+6% (+)	0% (--)	-7% (=)
Eastern	+5% (+)	+8% (--)	+1% (+)
London	+11% (=)	+2% (+)	-8% (++)
South East	-10% (++)	+5% (-)	-1% (=)
South West	-4% (+)	+16% (++)	-4% (+)
Wales	-14% (++)	-13% (++)	-9% (-)
Scotland	-8% (--)	-8% (+)	+2% (+)

Explanation of the table:

The percentage figures represent the trend rates for workload and workforce in comparing the average level in 2021 and 2022 with the long-term average for the period 2015 to 2022.

Data in brackets is short-term movement of workload and workforce based on full year-on-year change between 2021 and 2022. (=) 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. Sub-national Construction Output Table 1 and Workforce by Region and Industry (JOBS05). New Orders and Output data is deflated to constant prices.



Zoom into: The impact of the rising cost of finance.

This Zoom into feature looks at the implications of permanently higher interest rates and highlights the markets that are most exposed to this long-term shift.

Higher interest rates are here to stay.

February 2023 saw UK base rates increased to a 15-year high of 4 per cent. Although rates may be near their peak, the days of rock bottom rates would appear to be over. Latest BoE data tracking effective interest rates for businesses other than banks reached a new high of 5%, and market expectations reported by CCLA and Bloomberg are for UK rates to still be above 3% by the end of 2026.

Demand for housing will inevitably be hard hit. Recent research by Savills found that the average mortgage loan is around £170,000. If a typical borrower were to update their loan in the current market, their payments would increase by over £400 per month. At the bottom end of the market, the withdrawal of the Help to Buy equity loan scheme could not have come at a worse time.

Commercial developments are doubly exposed. Not only have finance costs increased by 400 basis points or more, but income streams and development values are reduced by a higher discount rate. This affects the economics of low carbon refurbishments and other spend to save schemes also. Lower development values could trigger further risks associated with loan to value covenants. According to Bloomberg, the global stock of distressed debt in Real Estate totals nearly $150 billion. Latest credit conditions data from the BoE reports an increase in levels of debt default for small and medium enterprises in Q4 2022. Furthermore, the report signals that demand for lending for capital investment and commercial real estate by medium and large firms is set to significantly decline in Q1 2023.

The public sector is also exposed to the upward shift in borrowing rates. Public Works Loan Board (PWLB) rates at which local authorities can access borrowing are currently above 4.5 per cent, having been just 1.2 per cent in late 2021.

Downgrades, delays, and other knock-on effects.

There is plenty of evidence of the broader impact of the interest rate cycle. Property related shares fell significantly during 2022, and the FTSE 350 Real Estate index is currently 33% below levels seen in December 2021. Given the hefty discount to asset value, developers are paying off debt with sales proceeds rather than taking forward new development.

Registered Social Landlords are also facing challenges. Ratings agency Moodys recently downgraded their baseline credit assessment of some of the UK's largest social landlords by one notch due to several negative factors including rent caps and higher interest rates.

Ultimately, viability challenges result in delays to projects. Enfield Council, for instance, is one of many Local Authorities that have been forced to revaluate much-needed sales-led regeneration projects. It recently paused progress on early phases of its £6bn Meridian Water regeneration as it sought to ensure the project continued to offer value for money, announcing that "all projects that rely on borrowing either have been or are in the process of being reviewed to ensure they remain affordable and deliverable".

In sectors where projects remain bankable including Build to Rent and student accommodation, some developers are choosing to sit on the side lines in anticipation of a more competitive construction market rather than commencing development at the peak of the inflation cycle. Similarly, funds with deep pockets and long investment horizons are preparing to acquire distressed assets at discounted prices.

Most exposed market sectors.

Are some sectors more exposed than others to current market conditions? The table opposite summarises the impact of increased costs of finance will have on key development sectors in terms of their capex plans and on their business plans. Evidence for such impacts is starting to emerge.

In January trading updates, for instance, major volume housebuilders Taylor Wimpey, Barratt Developments and Persimmon all said that they would ease up on buying and developing new land. Persimmon said it has paused or renegotiated terms on around 30 development sites, while Barratt cancelled 22 previously approved land purchases.

	Positives	Negatives
Private Housebuilders	• Reduce pace of land acquisition. • Slow down build rate. • Focus on developments that can be phased. • Change scheme mix (e.g., BTR).	• Short-term positive cashflow • Downsize landbank and future development pipeline. • Reset asset values – e.g., landbanks.
Commercial developers	• Scheme delays - viability challenge and pre-lets • Downscale scope – e.g., light vs. heavy refurbishment options	• Less attractive asset class – repricing • Discounted asset values – benefit of paying down debt. • Distressed asset risks and opportunities • Lower LTVs - Larger equity requirement
Logistic developers	• Phased development and smaller lot sizes • Minimise infrastructure development	• Secondary effects of changes to tenant expansion plans • Long term demand trend vs. short term correction • Land value discount and project distress
Local authority developers	• Delay/cancel programmes. • Change scheme mix.	• Reduced revenue from high-yield assets (new and existing) • Exposure to illiquid assets • Increased finance costs and long-term refinancing liabilities

Market conditions are clearly tough, but development is still going ahead. Logistics is potentially one of the most exposed sectors given recent rapid growth. However, specialist developer Segro recently advised that 75% of its 10m sq. ft development pipeline is either pre-let or under offer. Even as the investment market is dragged down by yield shift, occupier demand is holding up.

In the affordable and social housing sector, low grant rates and falling sales values mean that housing associations will need to increase borrowings as a percentage of development costs. Grant rates are being reviewed by funding bodies such as the Greater London Authority (GLA) in response to the viability challenge. However, Registered Providers (RPs) taking out new debt will be paying 6% for 30-year finance rather than 3%, according to data from the Housing Finance Corporation.

Evidence from the Regulator of Social Housing (RSH) says that RPs are planning to agree £47bn of new debt over the next five years, including refinancing, increasing the sector's debt facilities to £129bn by 2026/27.

The RSH adds that whilst around 80% of debt in the sector is fixed, many providers have at least 25% of debt at variable rates.

Servicing debt costs is an increasingly big issue in local government with at least five Local Authorities exposed to large property and investment-related liabilities. Woking Borough Council recently warned that it is in the "territory" of issuing a section 114 notice as the authority's debt is set to reach £2.4bn. Croydon Council is seeking a £500 million bail-out to help deal with the consequences of a £1.6 billion debt burden that includes £320 million of negative equity exposure.

The analysis highlights that there are few sectors that are unaffected by an increase in costs of finance. In the same way that constraints on the UK's sustainable growth rate is likely to hold back the pace of the wider GDP bounce-back, higher interest rates will also weigh down on the speed of the construction sector recovery.

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Arcadis

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