ARCADIS

Market View
Summer 2024

The only way is up.

Introduction

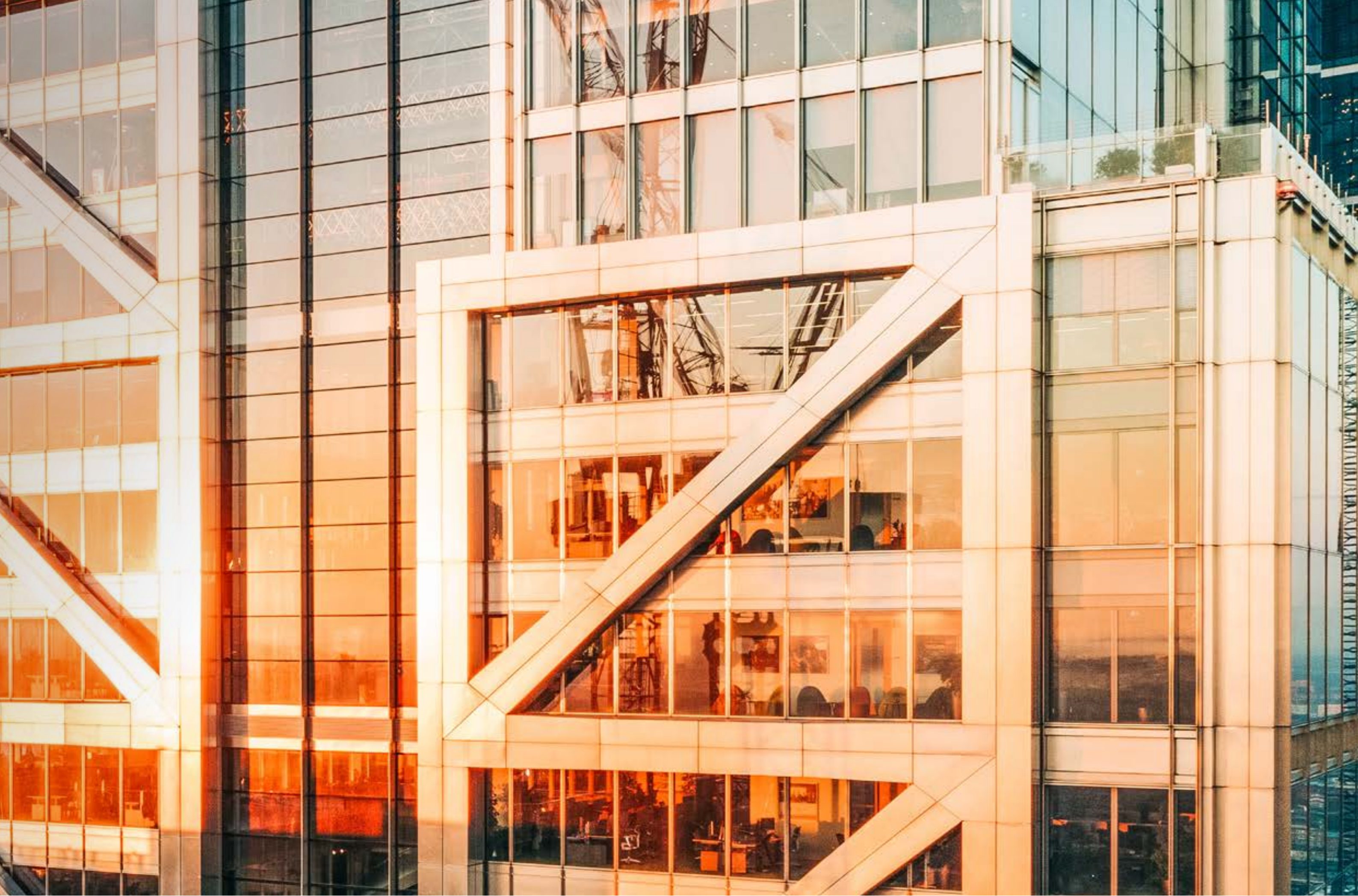
First some good news: the mood music is improving in the construction sector. However, even if the bottom of the investment market has been reached, strong headwinds mean that it will be some time before increased confidence converts into a new wave of construction projects. In the meantime, stalled 2-stage procurements mean that contractors' capacity for pre-contract work is constrained, reducing competitive pressure. With material prices on the turn and long-term demand for labour increasing, clients and contractors should prepare for a future uptick in prices.

The economic outlook turns positive.

After an unusually weak 2023, news that the UK had exited from a shallow recession was greeted with relief. Growth of 0.6% in Q1 2024 is the fastest quarterly rise since the end of 2021. Both the Bank of England (BoE) and the International Monetary Fund (IMF) upgraded UK growth forecasts to 0.5% this year and to between 1.0% and 1.5% respectively in 2025. However, this could be about as good as it gets for 2024. April's 2.3% Consumer Prices Index (CPI) reading was above predictions, leading markets to bet on a delayed interest rate cut in August.

Stickier services inflation was behind the higher-than-expected CPI numbers and is a sign that the recovery, when it comes, is likely to be consumer rather than business-led. The latest GfK consumer sentiment survey, while still negative overall at -19 in April, suggests that consumer confidence is at last heading in the right direction. Demand for investment goods remains subdued, and the construction sector may well have to wait longer for its own recovery.

The declaration of the UK general election won't help. A short-term hiatus in decision-making is already clear. Transport minister Mark Harper has delayed decisions for six months on three major infrastructure projects, including the £9bn Lower Thames Crossing, to allow new ministers to enough time to consider very complex planning proposals. While the summer election does mean that fears of an end-of-year, 'cliff-edge' Spending



Review have diminished, there is still little discussion from either main party about how they will meet their fiscal rules. Latest analysis by the Institute for Fiscal Studies (IfS) forecasts that under current projections, unprotected revenue budgets will face cuts of between 1.9% and 3.5% per year, or between £10bn and £20bn by 2028–29. This will be coupled with cuts to net investment of around 7% per year, in real terms. We examine the potential impact of the election on future spending in our Zoom into: Election Policies.

Construction activity tends to lag behind changes in the wider economy, so we will need to see a more broad-based improvement in outlook before we can be confident of a construction recovery. In an early sign, the latest S&P Construction PMI recorded a figure of 53.0 in April, the second successive month above the growth threshold of 50. Elsewhere, both the RIBA Future Trends Workload Index and the latest RICS Construction Monitor survey recorded positive readings for the first time since mid-2023, with the latter also recording the strongest reading for 'new business enquiries' since mid-2022.

What needs to happen to kickstart a construction recovery?

In the Spring Market View, we asked what factors might trigger a recovery, with investment in energy transition being a significant driver of new demand. A boost will certainly come from National Grid's May announcement of a five-year, £31bn UK investment plan, including £23bn for the electricity transmission system – a 250% rise on previous levels of spend. Recent infrastructure framework announcements, including the £3.5bn Eastern Routes Partnership for Network Rail and a £3.6bn AMP8 plan for Northumbrian Water, highlight the importance of infrastructure for many contractors, albeit that the work may take some time to convert.

By contrast, the housing market is still in the doldrums. Latest data from the National House Building Council (NHBC) showed 21,967 new homes were registered in Q1 2024, down 20% year on year and at levels last seen in 2009. Among the volume builders, Persimmon and Taylor Wimpey have both stated recently that their spring selling season was progressing at planned low levels, delivering c.10,000 homes each this year. This represents a fall of 30% on delivery in 2022. Elsewhere, a bunged-up planning system, together with issues such as Building Safety Act gateway approval delays, means that progress for many schemes is slowing rather than accelerating.

On a much more positive note, latest construction new orders data saw a double-digit QoQ rise in Q1 2024. In practice, total orders of £1,436m are still about 3% lower than the same period last year and 13% below the long-term quarterly average since 2015. Meanwhile the trend for a declining construction workload, seen since June last year, has continued, with a 1.8% QoQ fall in the value of new work output in Q1 2024.

The combined squeeze of declining workloads and weak new orders will inevitably add to the pressure felt by many construction businesses. Latest data from insolvency specialists Begbies Traynor showed that the level of construction firms in 'significant' financial distress was up nearly 39% in the twelve months to the end of Q1 2024. In a further blow, a May 2024 survey from the British Merchants Federation (BMF) shows that material suppliers were struggling to secure appropriate levels of trade credit insurance, reducing the ability of their clients to finance work through borrowing. Restructuring continues. Osborne and ARJ Construction have gone into administration, whilst Australia's Lendlease has announced it is pulling out of the UK and selling its overseas construction businesses. Some contractors are performing strongly despite tough market conditions. Multiplex, for instance, almost trebled its profit in the UK and Europe after a "strong" year in 2023, Tilbury Douglas saw 25% revenue growth and returned to profit last year, while Galliford Try reported "strong momentum" and is likely to see revenue and profits 5% higher than earlier forecasts.

Some positives in UK Commercial Real Estate

One of the sectors showing early signs of a turnaround is Commercial Real Estate. From an investment perspective, a notable move has been the launch by Great Portland Estates (GPE) of a £350m rights issue to "take advantage of the attractive new acquisition and development opportunities emerging in central London". Their belief that "values are now at or around their cyclical trough" is reflective of deal data from BNP Paribas Real Estate, which showed 'decade-high levels' of commercial property investment activity from US buyers in Q1 2024, recording a 68% YoY increase to £3bn in the period – above both the five and 10-year quarterly averages. Meanwhile Savills report UK investment volumes of £8bn in Q1, which, if the trend continues through 2024, would mean a 12% increase on the £28.4bn total recorded in 2023.

Moreover, Glenigan's Q1 2024 Construction Review showed planning approvals for office projects over £100m in value were up 239% year on year. There was also a sharp rise in main contract awards for offices, up 115% on the previous quarter and 5% on the same period last year. Such projects will help to fill an emerging shortfall in the office construction pipeline, as schemes started after Covid approach completion.

However, as our Spotlight on: The Contractor Pipeline feature highlights, planning approvals and early-stage procurements are not converting quickly into work on site. Viability and confidence challenges mean that some projects are stuck in later stages of procurement, with the knock-on effect that site teams may not have projects to roll on to.

Forecast

Political parties might be promising change as part of their election campaigns, but there are few concrete signs of improvement for the construction supply chain.

Our introduction highlights signs of improvement that are essential preconditions for a more broad-based uplift in construction activity. However, with many projects stuck at various stages of procurement, the one area where contractor capacity is highly constrained is pre-construction services.

A new inflationary outlook

In our Summer 2024 forecast, whilst we highlight that challenging market conditions will prevail throughout 2024, we turn our attention to a more inflationary outlook for the recovery phase – particularly from 2026 onwards – as resource constraints bite.

There are multiple causes of the present bottlenecks – some time dependent and some market dependent:

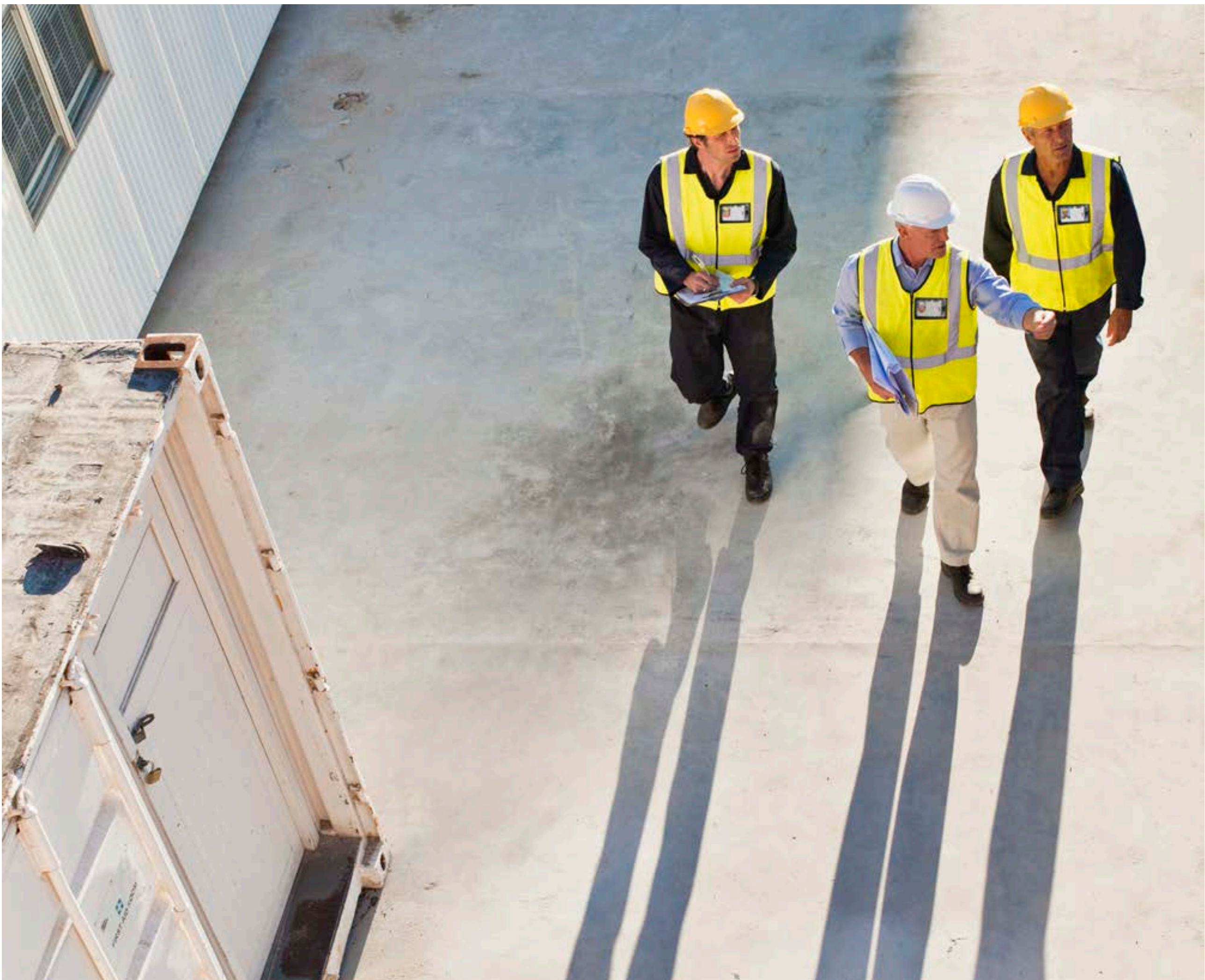
Time dependent blockers. The obvious programme-related blocker is the general election with its impact on decision-making directly though the period of political sensitivity and spend planning or indirectly through the creation of a 'natural break' for investors.

The early implementation of new approval processes is, of course, also influencing progress. Arcadis analysis of residential developments highlights that whilst 75% of high-risk schemes requiring a staircase redesign have recommenced development, all are in a holding pattern with respect to the Building Safety Act Gateway 2, with no submissions made. With a minimum three-month review period, it is unlikely that many of these projects could start on site during 2024.

Cyclical blockers are affecting most sectors at roughly the same time:

- **Market-driven sectors** including housing and commercial development face viability and affordability challenges. Even as an expected cut in interest rates this summer boosts confidence, transaction rates will remain low – particularly in the housing sector – further delaying commencement.
- **Regulated sectors** are coming to the end of their current control periods, which typically results in a reduction in activity as new teams, processes, and programmes bed-in.
- **Public sector programmes** need to be reconfigured to account for new price levels and future reduced spend volumes. Integrated teams are working hard to get projects to stack-up – even as spending priorities might change following the election.

Our revised assessment is that these blockers will take longer to clear during 2024, and that as a result, growth conditions are unlikely to improve this year. By the time that the bottleneck starts to clear in 2025, more projects will be competing for resources and more capacity may have been lost. These are conditions for an inflationary recovery.



Projects on the runway but no clearance to fly

A weak project pipeline is usually associated with downward pressure on resources and prices paid. But this does not appear to be happening in the current cycle.

There are many reasons why demand signals have not fed through into pricing – even as inflationary pressures have dissipated. Loss of contractor capacity through business failure and the potential for labour shortages across the sector help to explain why prices have remained sticky, even as viability pressures have ramped up.

A further explanation is that increasingly contractor teams are finding themselves committed to project opportunities let on a two-stage basis. In the event of a delay to the second stage award, teams stay committed to the project. We discuss this further in our Spotlight on the Contractor Pipeline.

The practical impact of this trend is that contractor capacity that could be deployed on new bids and opportunities is stuck in a holding pattern – committed to resourcing projects that may not go ahead, reducing the capacity of both main contractors and their sub-contractors to respond to future opportunities.

This is not solely a private-sector issue. Early Contractor Involvement (ECI) appointed contractors in the public sector working for central and local government as well as the delivery agencies are also committed to a substantial forward pipeline of work at the second stage of procurement that might not start on site unless affordability challenges are solved.

The immediate consequence is that, even as contractors run down their existing project pipeline, reportedly full contractor order books have created a capacity constraint for clients looking for teams to bid for future workload. A further consequence is that if delayed projects are not awarded soon, much-needed sub-contract workload will also stall, creating a further downward spiral in demand and capacity. Unfortunately, in the current slow-moving market, tomorrow's supply chain is being reshaped by today's delayed procurements.

Materials prices – on the move

As predicted in our Spring Market View, construction material prices have started to increase.

Prices for a basket of common construction materials are still 40% above pre-Covid levels, based on Department of Business and Trade (DBT) data. In common with the wider economy, a new prices baseline has been set. Background inflation is also starting to re-establish itself in the materials segment with a growing number of categories seeing price growth over the past three months. Transport costs are also still high, notably for container routes from China where rates are up by 45% in the past month compared to levels last seen in January 2024.

Latest DBT data records positive inflation across four baskets of materials associated with different construction sectors including house building and repair and maintenance. House building was exposed to 1%+ inflation in the past three months. Timber prices are beginning to bounce back and a widely reported 30% hike in the cost of some insulation products will have been an unwelcome development on many projects.

A return to annual inflation of around 3-4% across all categories is likely, although there will be a lot of variation across categories as supply and demand fluctuates. The balance of supply and demand is a growing concern – particularly as industry starts to consider the shape of a recovery. Brick stocks, for example, are at their highest level since Q4 2016 at 529 million, but with both Forterra and Ibstock having restructured in the past 12 months, there is some concern that capacity might not meet demand if plans for accelerated housing delivery were to crystalise.

With commodity prices mostly staying soft, long-term worries about industry capacity are, for now at least, taking precedence over short-term fears over market fluctuation.

Labour costs – conflicting signals

The labour market is another area where concerns are building about future capacity, even as current data suggests that demand is still soft. As projects remain stuck in procurement and as existing site teams roll off their current schemes, short-term conditions favour clients and contractors.

This is illustrated by current average weekly earnings collected by the Office for National Statistics (ONS), which in the construction sector increased by only 1.8% in the 12 months to April 2024, compared to 5.9% for the whole economy. Given that directly-employed operatives secured increases of 8% in 2023, the main explanation for weak earnings growth is likely to be a fall in rates paid to the self-employed. Hudson's Contracts corroborate this, tracking falling monthly average earnings across most regions and trades during early 2024.

Wage deals agreed so far for directly employed labour for 2025 are falling into the range of 3-5%. Services trades agreed two-year deals in 2023, guaranteeing a reasonable increment in the second year. The Building and Allied Trades Joint Industrial Council (BATJIC) has also recently agreed a one-year deal at 4% for general building trades, starting in July 2024.

The outlook for the recovery of the labour force is challenging. The Construction Industry Training Board (CITB) has recently upgraded its five-year labour force projection by 12% to 50,300 per year on the back of forecast growth in housing, infrastructure and repair and maintenance. However, in practice, the workforce declined by more than 30,000 during 2023 according to the ONS, led by a massive 5% (69,000) fall in the size of the directly-employed workforce. Growth in self-employment helped to compensate for this.

Construction's challenge to attract its future workforce has become much harder following reforms to legal migration rules that have increased minimum wage rates to more than £38,000 a year for skilled occupations and which will include the abolition of the Shortage Occupation earnings discount. The end of the Construction Skills Certification Scheme (CSCS) Grandfather Rights at the end of 2024, requiring all operatives to have relevant qualifications, could also trigger an exit of older, UK-based operatives from the industry.

Currently the industry lacks a joined-up plan to address these challenges, and labour shortages could become a more significant challenge as recovery accelerates.

Forecast – the only way is up

The introduction to our forecast highlights a growing wave of optimism around the UK economy. Our view is that growth will be consumer-led and that intensifying headwinds will delay the start of a construction recovery.

The calling of the general election will inevitably disrupt project-related decision making during the summer. These effects will build on other factors related to market and spending cycles that will slow the new project pipeline. Even as clients bring forward new schemes in the light of an improving long-term outlook, the recovery in on-site work will be slow, with protracted procurement processes.

We do not expect to see a significant upturn in work on site before mid-2025, reflecting challenges in bringing forward residential projects under the new Building Safety regime, and the timescales needed to bring forward the next phase of commercial and public sector schemes. As a result, we predict lower inflation in buildings markets up and until early 2025.

The continuing hiatus in workload in the building sectors will make it difficult to keep resource in the industry. We agree with commentators that the recovery phase will be challenging and have lifted our inflation forecast for late 2025, 2026 and 2027.

For infrastructure, we hold our view that the sector will see a 'K' shaped inflation trend, with relatively-low levels of inflation in the rail and road sectors and higher levels of escalation for networks, driven mainly by demand and scarcity as large-scale programmes start.

This forecast is subject to greater levels of uncertainty than usual. The potential for policy change under a new government triggers uncertainty related to the timing and extent of future spending, whilst the stickiness of services inflation may reduce the Bank of England's room for manoeuvre in cutting interest rates. Lendlease's recent announcement concerning the future of its UK businesses could also have an impact on the competitiveness of the UK's major project contractor market and could also result in delays to important urban regeneration schemes in key city locations.

Our amended summer forecast is 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% (3-6%)
2025	3-4% (3-4%)	3-4% (3-4%)	3-7% (3-7%)
2026	5-6% (4%)	5-6% (4%)	4-7% (4-7%)
2027	5-6% (4%)	5-6% (4%)	3-7% (3-7%)
2028	5-6% (4%)	5-6% (4%)	3-8% (3-8%)
Total	**21-26%**	**21-26%**	**21-42%**

Source: Arcadis

Inflationary drivers	Deflationary drivers
• High levels of workload in network infrastructure.	• General economic slowdown
• Lack of capacity in bid teams resulting in low levels of competition	• Order book replacement across most sectors.
• Supply chain consolidation.	• Attitude to work winning
• Attitude to risk transfer.	
• End of structural deflation cycle	

Zoom into: Election policies.

Ahead of the publication of detailed manifestos (when going to press), we review earlier policy announcements and how they might affect the construction sector, given tough financial constraints.

As highlighted in the introduction, current fiscal rules imply revenue spending cuts to unprotected budgets of between 1.9% and 3.5% per year, whilst capital investment is set to fall sharply in line with inflation.

Much of the public investment programme is already well defined. Rail and road settlements are in place and both parties are committed to defence investment including the upgrade to the UK's nuclear deterrent.

Changes to infrastructure costing and delivery

Following a review into major capital projects, Labour has announced a plan to merge the Infrastructure and Projects Authority (IPA) and the National Infrastructure Commission (NIC) into a single organisation – the 'National Infrastructure and Service Transformation Authority' (NISTA). NISTA would set the planning, design, and cost criteria that projects must meet before funding is released. The move has been broadly welcomed by the industry and highlights that a new Labour administration would be likely to make infrastructure a priority. However, merging the two bodies would take time, so any positive impact wouldn't be seen for several years.

Other changes being floated include greater delegation of control over funding to Mayoral Authorities. A shift to five-year funding deals would be a positive step but could also result in resources being spread too thinly.

Renewable energy

Both parties have ambitious renewable energy targets. Labour proposes to go further, setting up Great British Energy (GBE), a publicly-owned clean power company. The GBE plan claims that it will improve the nation's energy security, cut energy bills, and help to decarbonise the power network. Capitalised at £8.3bn, early statements suggest that GBE's two primary functions would be to firstly act as an anchor investor alongside private sector parties in new technologies, particularly floating offshore wind, and secondly to invest in local supply chains, underpinning skilled employment

The other dividing line between the main parties is oil and gas, where Labour vows not to issue further licences for oil and gas exploration in the North Sea basin.

Housing

The current government made planning reform a centrepiece of its legislative programme but will be remembered for making housing targets officially 'advisory' rather than mandatory. Labour has pledged to re-introduce a mandatory target of 300,000 homes per year over the next five years.

Speaking at UKREIIF 2024, shadow housing secretary Angela Rayner outlined Labour's plans for setting up new towns across the UK, including a target for 40% social and affordable housing. Sites would be chosen within a year of a new Labour administration. Most of the up-front investment is expected to come from the private sector, so it will be interesting to see what incentives are put in place to attract this early spend, should this proposal be taken forward.

Outgoing housing secretary Michael Gove, who is stepping down at the election, has previously pledged that Cambridge would be one of the key areas for investment under a Conservative government. His 'Case for Cambridge' plans for 150,000 new homes – three times as many as the 'ambitious' housing target set by the city's own planners. However, this plan could be derailed by constraints associated with a lack of water to serve existing housing in the area, let alone a further major development.

Planning

Planning issues have been a major bugbear for the construction sector over the years, with increased regulation and the slow pace of decision-making regularly cited as key reasons for projects being delayed or rendered unviable. The Conservatives have pledged to introduce league tables to expose underperforming local planning authorities as part of the recently published NPPF and introduced significant updates to the infrastructure planning system.

Meanwhile Sir Keir Starmer aims to 'bulldoze through' the planning system in England if Labour wins power, allowing easier brownfield development and creating a new 'grey belt' land class for construction on poor quality areas of the green belt. Progress during the last parliament proved how controversial, complex, and time-consuming planning reform can be. A future government may be in a stronger position to deal with vested interests, but initial progress on housing and infrastructure delivery will rely on existing systems.

Pro-growth investment will be key

Given tight fiscal rules, the growth agenda will be key to the success of any new government. Weak growth over the past two years means that measures to accelerate recovery will trump almost every other policy. Pro-growth investments in education and skills development, R&D, public infrastructure and a sustainable environment could well be the hot spots over the next five years.

While there is a feeling in the construction sector that the election can't come soon enough and will hopefully lead to more certainty in the market, in reality there needs to be more policy detail to establish how positive the outcome might be. Plans for schools, hospitals and broader decarbonisation remain outstanding for example. Responding to measures taken to increase the pace of growth will be key for the construction sector to plan for its own recovery.

Spotlight on: contractor pipeline

One of the greatest challenges for clients in the current market is the difficulty in attracting contractors to bid for new projects. This shouldn't be the case. After more than 12 months of shrinking order books, contractors would ordinarily be eager to add new opportunities to their new business pipeline. With a glut of post-Covid projects coming to completion in 2024 and 2025, contractors surely need the work but many claim to have full order books. What is going on?

There are many explanations. Contractors are certainly being more selective in their choice of bid opportunities, investing in long-term relationships and only choosing to work on projects with acceptable terms. But there is more to this than a conservative bidding strategy. Across the public and private sectors, bid team availability has been squeezed, even as contractors invest in their work-winning strategies

Another explanation is the client's preferred approach to project procurement, and whether this is making best use of pre-contract resources. Post Covid, two-stage tendering has become the default option on many projects, derisking the bid for the main contractor whilst securing specialist input from the specialist supply chain through early engagement. Variants of two-stage procurement were the most common in use in our latest in-house survey. Reliance on two-stage has extended to high-risk residential buildings, where specialist input is needed at an early stage to prepare a safe and compliant design for the gateway process. Public sector clients also use a two-stage model as part of their ECI strategy.

Two-stage procurement gives the supply chain much

greater confidence in their future pipeline, but when projects get stuck mid-procurement, teams get stuck too. At Arcadis, we are increasingly aware of contractor teams caught in a 'holding pattern,' either waiting for a client approval or still working pre-contract to produce a deliverable, viable scheme. In these circumstances, the sunk investment in the project and client relationship makes contractors reluctant to walk away from a probable contract, particularly when new opportunities will be let in a more competitive environment.

Based on our latest market analysis, this pipeline of stalled projects is unlikely to unwind quickly. Commercial schemes face the most favourable conditions as developers position for the next upward cycle. Residential schemes potentially face longer delays, not only because of weak demand but also due to new process steps associated with the Building Safety Act that will further delay a start on site. Public sector investment priorities could change and there is little prospect of more funding to address viability issues.

The implication is that a tight market for contractor bid teams will persist – even as workload levels continue to fall. This means that clients will continue to find it difficult to attract their panel of contractors – not because their project is not attractive, but because the teams are committed to slow-moving opportunities.

In such a market, what actions could clients take to engage with their potential contractor base to ensure an effective procurement action? We would recommend the following steps:

- Undertake Expression of Interest engagement with a wide range of potential bidders at an early stage – obtain quick insight on market dynamics.
- Commit to regular and clear communication with bidders throughout the bid process – acknowledge the investment made by the contractor in the project opportunity.
- Consider whether alternative procurement strategies could free up more bidder capacity – e.g. rapid single-stage tender action on smaller, lower risk schemes.

A reduced level of competition on projects is likely to persist. As the market recovers, projects that are still in the second-stage holding pattern will eventually move forward, absorbing contractor and supply chain capacity. Developing the project proposition to attract contractors whilst the market is stuck will equip clients and project teams for when markets pick up.

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Arcadis

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