Market View
Winter 2024

Stuck in the middle

Introduction

A slowing economy and a tax-raising Budget have done few favours for the construction sector. Viability hurdles are increasing rather than diminishing in many sectors, with high-density residential developments struggling to maintain momentum through statutory stage gates. However, regulated sectors including water and energy have much better prospects as clients prepare for new investment programmes.

In the Arcadis Winter 2024 Market View, we look at how economics and politics have combined to dampen optimism in the construction sector. We reflect on high-profile industry developments including growth trends and business failures as well as the recent Budget and what this means for industry prospects. The stark headline is, for the time being at least that progress is likely to be slow—large parts of the construction sector are simply stuck.

UK economy – slow progress

While the UK recovery is still underway and the economy is broadly on track, there is a growing sense that progress is stuck. UK GDP growth increased by just 0.1% in the last quarter, a marked slowdown from the 1.2% growth seen in the first half of this year.

The biggest event in the past quarter was Chancellor Rachel Reeves' first Budget. The positive impact of a £100bn boost in capital spending was blunted by increased business costs related to the National Living Wage (NLW) and employers' National Insurance Contributions (NICs). This will add to headwinds, which include a potential slowdown in the pace of interest rate cuts in 2025. The Office for Budget Responsibility (OBR) suggests that Budget policies will temporarily boost output in the near term but will leave GDP largely unchanged in five years. We look in more detail at what the Budget covered and what it means for the construction sector in our Spotlight section of this report.

Not all sectors are stuck. The regulated utilities are about to enter a new cycle of investment, and public sector clients now have clarity on their capital allocations for 2025/26. Commercial property investment markets also appear to be on the turn. Real estate investment trusts (REITs) focused on commercial and retail property—including British Land, Land Securities and GPE—are reporting an increase in asset values for the first time in two years, boosted by upticks in retail properties and London office buildings. Large office assets have also been put up for sale, including Nuveen's 'Can of Ham' and Brookfield's CityPoint Tower, testing the investment market and potentially opening opportunities for the recycling of capital. But as Deloitte's recent weak office start data for the London development market' showed, there will likely be a lag before this feeds through to schemes on site.

Things are tougher in residential markets, despite the latest RICS residential survey continuing to show positive trends in sales volumes. Viability and regulatory issues are still major barriers to progress, even as interest rates fall. This is especially the case with apartment schemes, with National House Building Council (NHBC) data showing an 18% fall in new registrations in Q3 2024 compared with a year earlier. The 4,386 total for apartment registrations was the second lowest Q3 reading in the last 15 years and 54% below the long-term Q3 average.

Government

Four months into a new government, there is a growing sense that the going is tough, and that progress will be hard to maintain. Newly-installed Ministers in the Department of Energy and Net Zero (DESNZ) and Ministry of Housing, Communities and Local Government (MHCLG) were super quick in scrapping the nine-year ban on onshore wind developments and in intervening on previously rejected plans for major data centre and film studio schemes. Government has also given the go-ahead for London City Airport expansion. But the full detail of the next Roads Investment Strategy (RIS3) has been pushed back until Spring 2025. Similarly, spending on the New Hospital Programme will be reprofiled as schemes are approved on a project-by-project basis. Reviews should mean the right projects are taken forward, but at the price of likely delay.

Chancellor Reeves' growth plan is, of course, much wider than the tax and spend agenda outlined in the Budget. Her maiden Mansion House speech in November was notable for its range of reform initiatives. Measures outlined included an overhaul of aspects of the UK pension system to create 'mega-funds' with better capacity to be able to invest in infrastructure assets. These are likely to be modelled on schemes in Australia and Canada, which invest three times more in infrastructure compared to the typical UK fund. While such initiatives above represent the government's ambitious growth agenda, there will be a time lag before these measures show results. For now, it can only be hoped that plans for housing and infrastructure investment create short-term gains and give the market a boost. The front-loading of the additional £100bn for capital investment planned over the parliament should benefit schools, housing and hospitals, but only if the money can be released in a timely manner and if enough shovel-ready projects can be deployed.

Construction

In the last quarter, the UK construction market has been overshadowed by the implications of past crises. The demise of the UK's sixth largest contractor—ISG—adds to a litany of significant contractor failures in recent times, with 10 major firms going into administration since June 2023, including Buckingham and Henry Group. These had a combined turnover of £4.5bn—equivalent to 3% of the size of the new build construction sector. Their failures highlight the weaknesses in the contracting model and potentially put key businesses in the supply chain at risk. More than 50 business were owed over £1m by ISG entities, for example. Meanwhile, the final report of the Grenfell Inquiry provided a devastating account of end-to-end failure that shames all parties including government, construction teams and clients and which requires significant additional reform. Over and above the challenges associated with building safety regulation, the impact of the tragic events at Grenfell Tower will continue to loom over the industry for years.

Despite the tough going, and although there are fewer reasons to be cheerful than expected, there are some faint signs of progress. After three successive quarters of contraction, the sector saw output growth of 0.8% in Q3 2024, with new work outpacing repair and maintenance activity for the first time since Q4 2022. Sentiment has been improving too, although it must be noted that most of the recent surveys were carried out pre-Budget. The October Construction Purchasing Managers' Index (PMI) from S&P Global marked eight successive months of growth with a solid reading of 54.3, well above the H1 2024 average of 51.4. Positivity is also evident in the latest business confidence index from the Institute of Chartered Accountants in England and Wales (ICAEW), where the construction sector recorded its highest reading for almost three years, and from the Royal Institution of Chartered Surveyors (RICS) where the

headline net construction workload balance of +2% in Q3 2024 was the first quarterly reading above zero since early 2023.

Many of these surveys highlight that infrastructure is the main driver of such optimism. This looks set to continue in the near future, with strong utility sector activity, for example, set to be a safe bet in 2025 and beyond. However, for the investment-led markets, times will continue to be tough. Glenigan's latest sector report shows that the value of detailed planning consents fell by 23% in the period between August and October, averaging £8.9bn per month, with industrial and offices being the main sectors affected. Stubborn inflation and continuing high interest rates will not help to break the logjam, particularly as project durations extend to accommodate new regulatory requirements such as the gateway process. Equipped with a better understanding of the operation of the Building Safety Act (BSA), clients and contractors are preparing for a long haul.

Conclusion – Stuck in the middle

In summary, while the fundamentals for growth in the construction sector are in place, the speed of recovery will be impacted by an increased cost base and deteriorating viability on one side and by increased risk aversion by clients and contractors on the other. Even newly buoyant sources of building sector workload including hospitals and student accommodation will be delayed by the stringent requirements of the BSA gateway process. In the meantime, rapid growth in the regulated utilities could crowd out investment into other infrastructure sectors. As a result, the recovery will be slower and will be more sector-specific, meaning that clients will really need to focus on the specific dynamics of their markets to get their timing right.

Forecast

Our updated forecast recognises that construction markets are likely to diverge further from 2025 onwards, resulting from a delayed recovery in the housing market and an acceleration of programmes focused on energy and water networks. Contractors will seek to pass through increased employment costs, but a continuing shortage of opportunity will maintain some downward pressure on inflation.

Workload

Even as construction activities levels increased during the third quarter, the sector's recovery was losing momentum. Construction's first post-election quarter showed some encouraging signs. Total new build output rose by 2% in real terms in the quarter, albeit totals remain well below 3Q 2023 levels. Positively, non-housing sectors including the public and industrial sectors are showing signs of a steady increase in workload.

However, the rug risks being pulled from under contractors' feet. New orders data from the Office for National Statistics (ONS), which can be taken as a good proxy for workload in the following year, fell rapidly in 3Q 2024. A strong recovery in orders, gathering pace since the beginning of the year has reversed, with most gains cancelled out. PMI data, tracking industry confidence, had been on the rise since January 2024, but is now losing momentum, led in particular by the residential market, reflecting weaker, post-budget business sentiment.

Whilst contractors' medium-term order books have been weakening over the past 24 months, the latest reverse points in particular to more difficult trading in the North East and North West, West Midlands and London. No single segment of workload explains the turnaround, although the housing pipeline is weak in regions associated with high-density housing including London and the West Midlands. A closer look at the data shows a deep across the board correction affecting all sectors with the exception of infrastructure, boosted by framework awards. Following this reverse, many contractors will be challenged to maintain levels of workload next year.

	Current price value (£m)	Quarterly increase (real terms %)	Annual increase (real terms %)
New orders	17,166	-22.0	-9.4
Output (new build)	34,066	+2.0	-4.1

Construction output and pipeline data, 3rd quarter 2024. Source: ONS

Feast and famine – the prospect of a divergent recovery.

Despite the short-term reverse, industry forecasting bodies continue to forecast a return to growth from 2025. Construction Products Association (CPA) published their latest forecast ahead of the Budget in October 2024, featuring a slight upgrade in new build and total workload growth.

	2025forecast (real terms %)	2026 forecast (real terms %)
New build	2.9	4.6
All work	2.5	3.8

Construction output forecast, 3rd quarter 2024. Source: CPA

Stronger growth in 2026 anticipates a rise in public non-residential spend on top of a residential recovery, which is likely to take longer to bring to market than suggested by government spending plans. As highlighted in our *Spotlight on the Budget,* the balance of departmental spending priorities is expected to switch towards social infrastructure including schools and hospitals over the next spending period—meaning that the total volume of investment in transport will remain level at best. Project opportunities, however, are changing in scale and content, meaning that different groups of contractors are likely to find differing levels of opportunity and competitive pressure in various segments. These are summarised below:

- **Mobility** – steady. Notwithstanding continuing large scale programmes on HS2 and Trans-Pennine Upgrade, the bulk of investment in national rail and road infrastructure will be focused on smaller scale schemes—favouring regionally-focused contractors. This trend will free national contractor capacity for focus on larger opportunities including major strategic investments for regulated utilities.
- **Energy** – in transition. MEP works will accelerate at Hinkley Point during the forecast period, representing a significant increase in demand. Specialist civil engineering resources may be able to deploy to a planned gigafactory prior to the commencement of works at Sizewell C.
- **Networks** – trending to scarcity. Assuming a positive outcome of the 2024 Price Review (PR24), investment in water networks is set to progressively expand over the next two to three years. This is likely to be a gradual process as new medium-scale projects are brought on stream. Whilst scheme development for the 21-strong major projects portfolio will take place during AMP8, relatively few programmes will start in the next two to three years, allowing for the assembly of suitable programme teams.

  By contrast, the £20bn transmission grid expansion programme let under Ofgem's Accelerated Strategic Transmission Investment (ASTI) framework is moving into delivery with a consequential impact on civils, structures and electro-mechanical trades.
- **Social infrastructure** – absorbing existing capacity. Welcome investment in schools is expected to enable production levels to return to volumes seen in 2023, stabilising existing supply chains. Health investment will benefit from a significant uprating of investment. However, with some hospital schemes likely to meet high risk building criteria, the pace of spend might be delayed by the complexity of compliance processes.
- **Commercial** – increasing momentum with pockets of scarcity. Following a post-COVID peak of completions in 2023 and 2024, volumes of commercial development across the UK are likely to stabilise as new stock is absorbed. Bidding activity will increase as developers plan for delivery into an under-supplied market in 2027/28. The UK data centre pipeline is the deepest in Europe, creating significant demand for specialist trades including building services, just as work in the energy sector increases.
- **Residential** – stuck. Whilst low-density housebuilding will return in line with sales rates, high-density schemes continue to stall due to viability and funding issues, exacerbated by uncertainties associated with the BSA. The pipeline for multi-storey residential is very weak, potentially freeing up significant contractor capacity in city centre markets as consented schemes continue to hit delays. With Gateway 2 durations extending out to at least six months and very few projects proceeding through the review, the recovery of this market will be further constrained by extended timescales associated with new compliance processes.

Construction materials

Construction deflation has continued to unwind over the past year, but this process may have temporarily stalled. The annual rate of deflation measured by the Department for Business and Trade (DBT) was -0.7% in September 2024. Price movement in the calendar year has been modest and, in many cases, inflation in some inputs (in-situ and precast concrete) have been cancelled by deflation in others including steel reinforcement. Reductions in the costs of steel and timber products have helped reduce inflationary pressure over the past three months.

Trends measured by DBT do not take account of scarcity, and clearly there are some sectors including electro-mechanical, where demand outstrips supply. With simultaneous growth in the energy generation and transmission, rail power and data centres, this trend can be expected to accelerate into the forecast period, creating differential inflationary pressure for sub-sectors.

Commodity markets are mixed, held back by slow growth in China. Energy prices are broadly stable, iron ore prices are falling as some steel sectors are contracting, but copper and aluminium, both linked to energy transition are starting to pick-up following falling prices earlier in the year.

Construction labour

By any measure, the construction sector has an accelerating labour problem. Using the ONS preferred JOBS metric, the potential size of the labour force has contracted at twice the speed of the contraction in workload since the market peaked in autumn 2023. The labour force may have been directed into the informal repair and maintenance sector or may have left construction all together. What is clear is that, as demands for specialist labour grows, industry capacity is constrained. This has been highlighted with industry vacancies increasing, even as workload has fallen.

Industry wages are expected to increase at around 3-5% in 2025, in line with two-year deals negotiated by MEP trades. However, rates for some scarce self-employed trades can be expected to increase at a much faster rate.

Irrespective of levels of demand for workload, we anticipate that the increase in employers' NICs, to 15%, due to come into force in April 2025, discussed in greater detail in our Spotlight on the Budget, will add 0.75 to 1% to construction costs. Sources of variability will include the extent to which project labour is self-employed and levels of pricing pressure experienced in project procurements in 2025 and 2026.

Tender price forecast

Our Winter 2024 Tender Price Forecast has been updated to reflect the impact of Budget decisions and the implications of a slowdown in the growth in workload from certain sectors including high-density housing. We also anticipate that growth in public sector investment may take some time to ramp up—reducing the risk of 'crowding-out' of private sector developers in the immediate future.

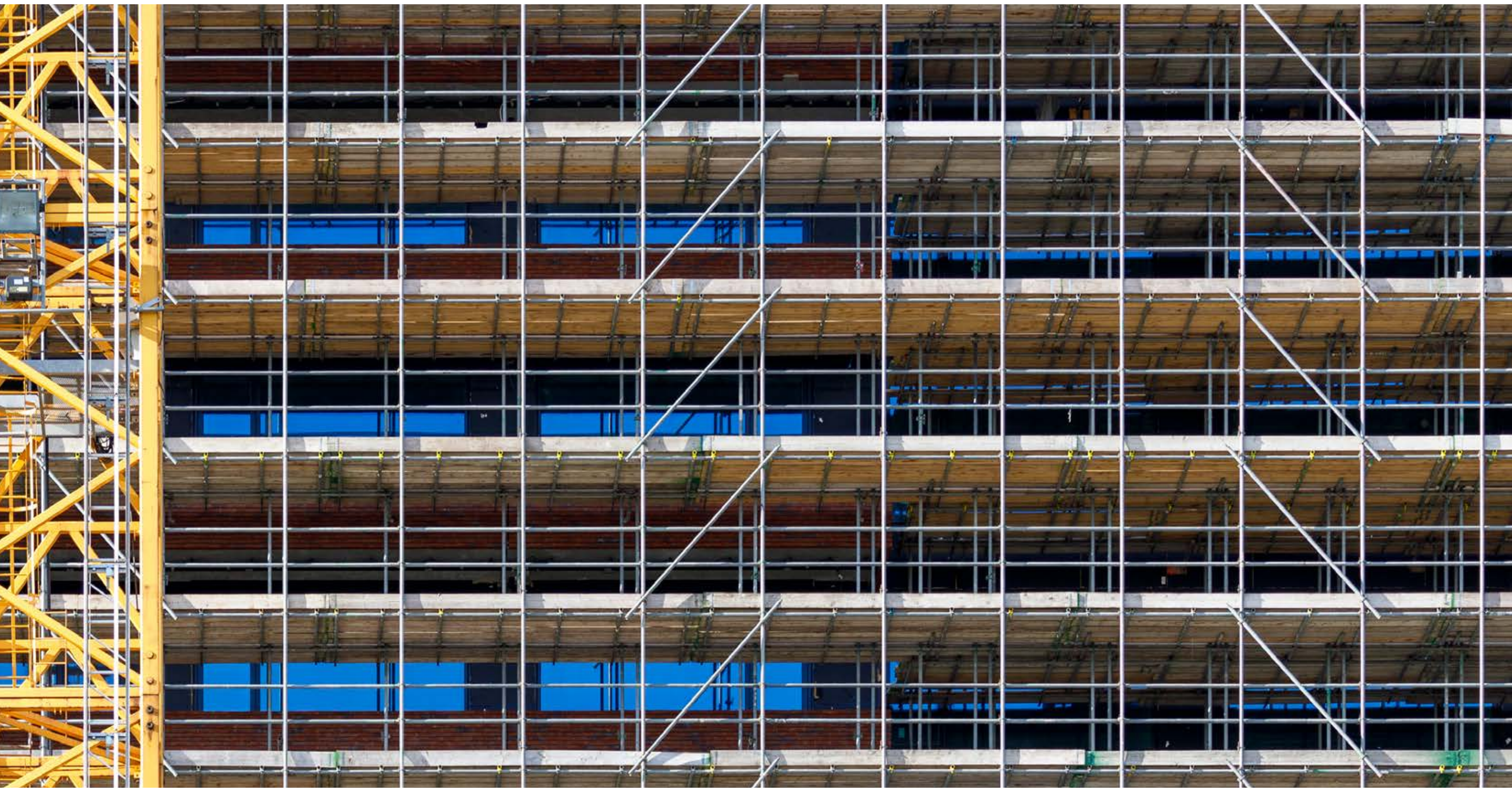
This includes the impact of National Insurance costs affecting both directly and indirectly employed labour as well as the labour component of the materials supply chain.

Another factor that we have adjusted in the building segment is attitude to risk. Our view is that, following the failure of ISG and the losses incurred by other buildings-focused main contractors, many will adopt a more risk-averse approach to bidding which is likely to result in higher tender returns. We feel that in the short-term, a change in risk attitude will have a greater impact than the potential loss of supply chain capacity in the aftermath of the ISG collapse.

The net effect is that we anticipate for buildings in 2025, the range of potential tender outcomes will widen. Increased competitive pressure resulting from the slowdown could result in lower inflation, on competitively procured projects, particularly if material costs remain in check and site labour rates fall. On the other hand, a combination of higher wage costs and risk aversion could in some cases result in a greater exposure to price increases, particularly on negotiated schemes. Changes in procurement practice associated with the BSA requiring greater early contractor engagement will also reduce opportunities for competitive bidding.

We have also reviewed and updated our forecast for 2026, anticipating that procurement volumes pick up. We maintain our long-term hypothesis that significant labour cost inflation will accompany any expansion in workload related to economic growth, housing targets or energy transition. The current slowdown is likely to delay recovery until 2026 and we have adjusted our projections in line with this. Our forecasts for 2027 and 2028 continue to be based on a growth and labour constraint hypothesis in advance of pipeline data.

The ranges set out in this table aim to capture most projects. Clients operating in markets exposed to extreme scarcity should consider the risk of additional inflation premia.



Our Our Winter 2024 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	2.5-4.5% (3-4%)	2.5-4.5% (3-4%)	4-7% (3-7%)
2026	4-5% (5-6%)	4-5% (5-6%)	4-6% (4-7%)
2027	5-6% (5-6%)	5-6% (5-6%)	3-7% (3-7%)
2028	5-6% (5-6%)	5-6% (5-6%)	3-8% (3-8%)
Total	**19.5-25.5%**	**19.5-25.5%**	**23-22%**

Inflationary drivers	Deflationary drivers
• Potential recovery of NICs from April 2025	• Slowing order book replacement across most sectors.
• Elevated levels of workload in network infrastructure.	• Soft material prices in 2024
• Loss of capacity for large project delivery in buildings	
• Supply chain consolidation	
• Attitude to risk transfer	
• Materials inflation from mid-2025	

Spotlight on: impact of the Autumn 2024 Budget

In our latest Spotlight on, we consider three key aspects of 2024 Autumn Budget announcements: the capital investment programme, the impact of changes to National Insurance Contributions and longer-term impacts of changes to the business tax relief as part of inheritance tax arrangements.

There has been widespread disappointment with respect to the growth-enhancing aspect of the Budget package, which was clearly focused on taxation and spending decisions rather than wider pro-growth policy decisions. Analysis published by the OBR highlighted that although spending commitments are equivalent to 2% of GDP, growth generated by public sector consumption and investment will largely be cancelled out by a parallel contraction in private sector consumption. Fortunately for businesses focused on the investment economy, overall activity is likely to grow as a result of the measures put in place, particularly in the period 2025 to 2027.

Subsequent to the Budget, further details of the Industrial Strategy and the Pensions Investment Strategy have been published. These are both long-term initiatives that could have a positive long-term impact, but which are unlikely to drive significant additional growth or investment during our forecast period.

As a result, the detail of the Comprehensive Spending Review (CSR), scheduled for Summer 2025, will be very important in mapping out how available capital resources will be used to crowd-in private investment through well targeted support and incentives.

Capital investment programme. In addition to a significant increase in levels of capital spending, the most important aspect of the investment announcement is a commitment to long-term planning through a 10-year infrastructure strategy, five-year capital budgets and bi-annually updated Comprehensive Spending Reviews. Chief Secretary to the Treasury Darren Jones has claimed that the strategy will be long-term, joined up, and will herald a decade of renewal.

Planned capital spending is front-loaded into 2025/26, which may not be plausible, with the largest two-year increases going to the departments of Health, Justice and MHCLG. Transport sees a real term cut of 3%, highlighting the pivot to social infrastructure. A lot more detail will be issued in Summer 2025 alongside the CSR, potentially including integrated settlements for Combined Authorities as part of English devolution.

National Insurance and the national minimum wage. Average earnings in the construction sector are around £40,000 and, as a result, the 6.7% increase to the NLW will have less impact than on sectors associated with low earnings including care and hospitality. Increases to employers' NICs to 15% are likely to have the following implications for the sector:

- **Labour**. Additional costs associated with directly employed labour will add 0.75% to 1% to construction costs. The timing and extent to which these costs are passed through on projects will depend on existing contracts and market conditions.
- **Materials**. Additional costs will also flow through the materials supply chain. Builder's Merchants will be exposed to NLW increases and potentially higher NICs associated with a part-time, low-wage workforce.
- **Casual labour**. Increased NICs could incentivise self-employment. Levels of self-employment are down by 35% since 2019, but the different tax treatment may trigger a reverse. However, the Budget also announced a crackdown on umbrella companies that are widely used in the construction sector.
- **Micro-businesses**. Construction is reliant on micro-businesses, and reforms to the Employment Allowance combined with NIC threshold changes could act as a disincentive to business expansion. The allowance equates to a zero NIC liability for a business employing four people.

Inheritance tax relief. Changes to Inheritance tax relief have triggered a high-profile, negative response from the farming community, but changes to similar reliefs for business owners may have a negative impact on the construction supply chain, which is highly reliant on small businesses. The measure will require payment of a 20% IHT liability over 10 years following the death of the business owner where business assets exceed £1m in value.. Issues associated with the measure include:

- **Accelerated succession planning** with risks for business resilience.
- **Perverse incentives** to consolidate/sell/gift a business at an earlier stage to mitigate taxation liabilities.
- Potential for **additional operating costs associated with the management/mitigation of tax liabilities**.
- Further **disruption and uncertainty** affecting a business following the death of the owner.

As highlighted in the introduction, the Autumn Budget is a net positive for the construction sector, particularly because it reversed implausible and highly damaging cuts in planned investment spending announced by the previous government. However, other measures in the Budget could be disproportionately damaging for small business and as a result could have a negative impact on the supply chain.

Zoom into: Teething pains on Gateway 2

At a recent Arcadis Contractor Forum attended exclusively by residential-sector focused London Contractors, none of the attendees could report the successful completion of a Gateway 2 review. The new development pipeline for 2025 and 2026 is looking very thin as a result. What are the implications for markets and what can be done to increase certainty of Gateway 2 outcomes?

Widely-publicised findings on progress made by the Building Safety Regulator (BSR) in processing and approving Gateway 2 submissions has highlighted the potential impact of approval processes on the timing of the recovery of the residential development market. As other building types with a residential component, including hospitals, could also qualify as a high-risk building, the implications for construction could be more widespread.

The original Freedom of Information Request submitted by the Fire Industry Association captured 1,018 applications from the first year of the BSR's operation, up until 16th September 2024. Whilst the headlines focused on the 146 applications that had been signed off as compliant, the 50% (532) that had either been rejected, withdrawn, determined as invalid or were 'awaiting further information'—are a huge cause for concern.

At a recent conference chaired by Arcadis Senior Director Simon Rawlinson, a senior BSR representative emphasised that a high failure rate demonstrates that the Gateway system is working—in that projects that fail to demonstrate compliance are being rejected. However, due to high levels of workload, not only have periods for determination been extended, but BSR has also reduced its communication channels with applicants. In practice, clients and their project teams presently face a six-month wait to get through the assessment process, with very little feedback prior to determination.

Details of the BSR's assessments highlight how complex the compliance requirements can be. Some areas should be clear, such as the planning of fire escape egress. However, the introduction of a second staircase has resulted in some clients exploring different options to achieve this—risking non-compliance. Other aspects of the regulations, including the design of combined kitchen/living areas have always presented regulatory challenges. However, clients may have reasonable grounds to consider that the level of detail required to demonstrate compliance is becoming disproportionate and that these requirements might have unintended consequences for the development model and the delivery of much needed housing.

Building Safety Consultants are responding to latest developments by recommending that clients adopt a risk-averse approach to procurement and design detailing—potentially developing the design of safety critical elements to RIBA Stage 5 Levels of Detail. Given that detailed design of the structure, MEP and life-safety systems requires the input of specialist contractors, this will require the early appointment of the specialist sub-contract supply chain, with a longer pre-contract period and the consequential loss of competitive tension during the second stage of procurement.

The BSR will rightly observe that the early engagement of the specialist supply chain will help to prevent the 'race to the bottom' identified by Dame Judith Hackitt as being at the root of the construction industry's safety failures. Furthermore, the opportunity to develop a coordinated design should result in less change and better-quality construction. However, clients will be concerned about the practical operation of the BSA change control system and their ability to flex their housing product in response to market requirements.

Clients' challenging experience of the first year's operation of the BSA will no doubt reflect a steep learning curve, and the particular problems associated with the sign-off of remediation schemes. Both project teams and the BSR will bed-in their processes. Looking forward, early BSR decisions will give following project teams greater certainty with respect to compliant solutions. However, with project durations extended by a minimum of six to nine months for regulatory approval and a further six months for detailed design work, the impact on project costs, project cashflow, funding requirements and risk profile will be significant. A worsening outlook for viability is a contributing factor to the deteriorating residential development market highlighted in our Winter 2024 Market Forecast.

BSR's implementation of the Gateways has stuck closely to the vision in the Hackitt Report. Gateways are clearly acting as a positive incentive to deliver safe and compliant housing. However, with the pipeline for high-density residential development shrinking at an alarming rate, the BSA may also have the effect of disincentivising the development of higher-risk buildings, with wider consequences for the delivery of much needed housing in built-up areas.

The lessons from the applications of Gateway 2 are clear. Developers and their advisors need to fully integrate the requirements within their commercial strategy, design process and approach to information management. Teams must also anticipate that Gateway 3 will require a similar level of discipline and forward planning if successful, timely handover is to be achieved.

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Arcadis

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