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GREEN SHOOTS IN THE CONSTRUCTION MARKET MAY BE WILTED BY RISING COSTS

AN OUTLINE OF COST AND MARKET DRIVERS IN 2014

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EXECUTIVE SUMMARY

- Increased construction activity in London and other strategic cities in the UK.
- Material and labour costs anticipated to increase by 3% to 5% in London and 2% to 3% outside of London.
- Contractors' overheads and profit percentage will start to increase in 2014.
- Contractors are becoming more selective over procurement routes as their appetite for risk reduces and therefore clients need to remain open minded.
- Main Contractors and Sub-Contractors more vulnerable to administrations and disputes as prices rise.
- Shortage of labour increases costs.
- Clients should ensure that Cost Plans are robust and up to date prior to commencing new projects.
- Clients should also take the opportunity to design out risk and obtaining better cost certainty.
- Increases in material lead times are due to industry demand.
- Important to ensure that the supply chain is solvent and capable of delivering the specific project.

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INTRODUCTION

This White Paper investigates the effects the world recession coupled with polarised demand in various regions economies (i.e. BRIC, Middle East) has had on the UK Construction market and how the market is showing signs of recovery.

It is accepted that the UK construction market was badly affected by the world recession that began in 2007. We are still recovering from the impact of this recession but we are seeing positive signs of recovery. The UK construction market contributes circa 8% to the UK Business Economy[1]. This demonstrates the importance of the UK Construction Market.

One of the effects of the recession was that public and private capital spending was withdrawn, resulting in the amount of construction activity in the UK also reducing significantly. A noteworthy factor to this, was the reduction in corporate spending, with the government announcing in October 2010 that there would be a cut of £81 billion to public spending, which would continue for the next 4 years of coalition government. Construction companies (Main contractors, Sub-Contractors, Construction Manufacturers and Consultants) had to reduce their expenses through the reduction of overheads (i.e. staff numbers, premises and equipment) and at worst entering into administration.

This had a dramatic effect on tender prices within the sector, as competitive prices were being submitted to maintain work and turnover. Since the recession began, tender prices fell considerably at first and then became reasonably stagnant during the following six year period. There are exceptions to this in areas that have undertaken major projects such as the London Olympics, Cross Rail and the King's Cross redevelopment project.

The construction industry has had a steady supply of projects but it has not been significant enough to drive tender and construction prices upwards during the recession period.

CONSTRUCTION MARKET WAKING AGAIN

We believe that the construction market is beginning to show encouraging signs of recovery, through the amount of enquiries being received. It is also becoming more evident in and around London with the skyline once again being clad with cranes, scaffold and the like.

Once again there seems to be enthusiasm around the construction market and people are speaking more positively. It is a good sign that people within the industry are experiencing encouraging signs and seeing green shoots.

1 - (Economic Policy and Statistics dated October 2013)

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This is supported by the investment market, where overheated locations such as prime city areas such as the West End of London has lead investors to move up the risk curve to develop and refurbish buildings with asset management potential. This is also evident in strategic cities and towns outside of the capital.

In the past the construction sector has been slow to progress in comparison to other industries such as manufacturing, automotive and technology markets. This is because these industries have adopted technology such as robotics and pre-assembled modules more readily.

However, the industry is now embracing development in Building Information Modelling (BIM), Off-Site Manufacturing and sustainable development and we are beginning to show the other markets that the construction market can keep pace and also be innovative. This identifies that while the market was stagnant, development within the sector continued and that real progress is being achieved.

FEEDBACK FROM THE MARKET

Press coverage of the UK Construction Industry is beginning to be more positive. Stories are being reported, such as “Almost 60% of Construction Firms expect growth in 2014”, Building, dated 3 January 2014. News of new projects being implemented are showing signs of capital spending once more. This may be at significantly lower levels than we have seen in the past, but never the less, it is positive.

This confidence in the Construction market is and will encourage greater construction activity either through evaluating old projects that were not commenced or considering new projects with more vigour.

Within the last six months (3rd Quarter and 4th Quarter 2013) we have started receiving feedback from the construction market that Sub-Contractors are beginning to increase their prices and be more selective about which sub-contracts they price. This is due to a number of factors: the capacity and capability of contractors that remain in the industry; rising material prices due the supply and demand of available materials; and the fact that there is simply more work in the pipeline.

The competitive stance of the construction industry will continue to ease further as more work enters the market and contractors begin to decline tenders, due to their limited workforce and availability to undertake the works.

With more specialist works such as piling, lifts, basement works and manufacturing slots (timber frame, glazing etc) we are starting to experience increased lead periods. As the construction market need increases, lead-in periods will either lengthen to manage manufacturer’s orders or alternative suppliers or technologies will be utilised to address the shortages.

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We are already experiencing feedback both from developers and contractors that construction prices are starting to increase. This information is being communicated to us through tender returns and liaising through discussions with main contractors and sub–contractors. The works that we have experienced being most affected are steel and concrete works i.e. sub-structure and superstructure works.

Main contractors are also reporting that the availability of skilled labour is restricted and this places limits on the amount of works that can be undertaken. This will also have an effect on the cost of labour as supply is considerably less than the demand required to undertake the works.

The labour shortage could be improved with the introduction of Eastern European workers including Romanian and Bulgarian construction workers being allowed to work within the UK from the 1 January 2014. However this will not significantly address the skilled labour shortages.

PRICE INCREASES

Since the middle of 2013, we have experienced material cost increases in the UK, particularly in London. Contractors are informing us this is likely to increase as the market begins to strengthen further. We have evidence to suggest from tender returns that increases are already occurring, which is due to the continued growth of the construction market and confidence returning to the market in the capital.

We believe we will see more common materials such as concrete (3% to 5% increase in price)[2], metals (steel 2.7% increase in price) [3] and glass (2% to 5% increase in price) [4] based products start to increase significantly in 2014 due to the amount of construction work in the pipeline and also the demand for materials coming from overseas.

With the above in mind, we are also seeing the reverse for copper. There has been a good supply to the market which has resulted in the price of copper falling. But as activity within the construction market continues, prices will start increasing but this may take more time for the effects to be felt.

We are likely to see oil based products decrease (3% in price in 2014) and then rise by 2% in price in 2015 [5] which is due to the fluctuating cost of crude oil.

2 - (Sika Limited dated September 2013)

3 - (Steel Baker Expand for 2014)

4 - (Glass Magazine dated May 2013)

5 - (EIU Economic and Commodity Forecast, December 2013)

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The world's economy is beginning to stabilise. We are hearing less news regarding the euro zone crisis, the US banking crisis and the UK recession. The negative aspect of this is that the demand on construction (and therefore materials, equipment and labour) will begin to increase resulting in supply issues. Therefore the above materials are likely to increase in cost alongside demand as there is only a limited supply.

The cost of employing qualified and competent labour will also begin to increase. This is due to the release of labour during 2008–2009 (where construction companies had to make redundancies) and a lack of investment in apprenticeships and training. School leavers and graduates were not encouraged to enter the industry either.

The workforce consequently declined during this period and as the market starts to gain momentum skilled and competent labour will once again be in demand. To address this shortage, an additional new workforce will be required, who will need to be trained and supported until they have sufficient skills and experience to undertake the required work.

The client's professional team (i.e. Project Managers, Architect, Structural Engineer, Services Engineer and Quantity Surveyors) was also affected by the downturn in the market as these skills were also released. As the market awakes, there is once again demand for these services which is creating a shortage. At this moment the shortage is being filled by professionals who are moving from the regions to London to service the market demand. This cannot always be the case and encouraging people into the industrial will not be easy.

These factors will lead to increased labour costs, and in the short term (2 to 3 years), restrictions on the availability of labour will limit the amount of work that can be undertaken until this labour shortage can be adequately filled. In the meantime, contractors will either have to manage their procurement very closely or pay a premium to obtain the labour required to undertake the works.

PROCUREMENT

The traditional procurement model is that a main contractor and his sub-contractors competitively tender a scheme and its trade / works packages. Once the contractor has validated the packages and included their elements of the works, they will then go through an evaluation process and then submit it to the clients' professional team for review.

With the construction market being depressed, we have experienced main contractor's overheads and profit (OH+P) percentages at zero or even being applied as a negative % in order to win work. This demonstrates which shows the importance that main contractors place on maintaining their workload and more importantly turnover.

With market confidence increasing and construction activity returning, the Main Contractor's OHP percentage will inevitably increase and we are already seeing signs of this.

It is evident that the contractor's preferred procurement method seems to be either two stage tendering or negotiated. We believe this is because it leaves the contractor with less exposure to risk and price fluctuations. These two procurement routes also allow the contractor to incorporate the current market conditions at the time of fixing the offer, with the knowledge that they are not in competition with other contractors at that point.

The reason for the above is because contractors are not willing to be exposed to the risk of price increases and inflation but would rather decline the work than provide a non-competitive tender or accept the risks within the works.

We anticipate that on major projects started early in the economic cycle and given the above factors occurring, we will see an increase in the amount of construction companies entering administration as their prices will have been fixed at the start of the project with little opportunity to incorporate any change in market conditions. We also anticipate an increase in the amount of disputes and contractors will be under additional pressures (cost increases, labour shortages, obtaining workload etc) whilst trying to complete the works.

CONCLUSION

In conclusion, we are seeing evidence that construction activity is increasing in the UK, particularly in London and also in strategic cities and towns in the UK.

Due to the current activity in London we would anticipate the cost of materials and labour to increase during 2014 by as much as 3% and 5%. The construction market outside of London is anticipated to grow in 2014 by as much as 2% and 3%.

The contractor's overheads and profit percentage will start to increase as a result of the market conditions and reduction in the pool of contractors willing to tender as they become more selective. We anticipate seeing a change in procurement routes, to two stage and negotiated influenced by contractor's reduced appetite for risk.

Clients should be aware that main contractors and sub-contractors will be more vulnerable to administration and disputes were they have entered into contracts prior to increase in activities and prices.

Clients commencing new projects or preparing to issue tenders should ensure that cost plans are robust and up to date. Clients must also remain open minded about procurement routes as contractors' will look to use their preferred procurement routes. Clients should use this as an opportunity to design out risk and get better cost certainty at the point of contract.

It is more important than ever for project teams to be more diligent at pre-qualification and interview stages to ensure that contractor's and their supply chain are solvent and capable of delivering projects (including procuring materials) within the programme parameters. Additionally, cost consultants and project managers should monitor contractors closely during the construction period to look for early warning signs of potential problems.