Fulkers Bailey Russell

Construction Market Report

May 2022 (Q2)

Fulkers
Bailey
Russell

Big enough to cut it,
small enough to care.

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Executive Summary.

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This report summarises our findings from reviewing the current state of the construction industry and is for the sole use of the recipient. It is important to note that the assessment of inflation is based on historic data and forecasts which have been used for guidance only.

The construction industry is experiencing an ever-changing economic environment following the easing COVID-19 restrictions, increase in energy costs, the UK leaving the European Union, the current war in Ukraine and the removal of fuel duty relief on red diesel. The effects of these events are leading to increased inflationary pressures on the market that are likely to impact the construction industry for a number years.

With energy prices escalating, this is adding an upward pressure to costs in all aspects of life. The production of some construction materials have a very high demand for energy, and we are seeing prices in steel and glass increasing more rapidly than had previously been envisaged.

Some of the factors which must be taken into consideration are:

- Longer lead in times due to high demand and recovering supply
- Increased price of materials due to increased manufacturing costs
- Increased cost of preliminaries to align with COVID-19 protocol
- Availability of labour due to increased construction activity
- Cost of labour due to competition
- Increase in plant running costs as a result of the end of fuel tax relief

There is a risk that we may be entering a period of stagflation where the economic growth slows but, at the same time, prices are rising due to inflation.

Inflation Review.

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2 Inflation Review.

It is important to note that the assessment of inflation is based on historic data and forecasts which have been used for guidance only.

2.1 Tender Price Index

A review of the tender prices shows an increase of 8.5% over the 12 months to Q2 2022. This is the highest rate of yearly tender price change since 2015 and 2016, when the post-financial crisis construction recovery was in full swing. Price inflation will continue throughout 2022 as acute input cost pressures remain across the construction sector.

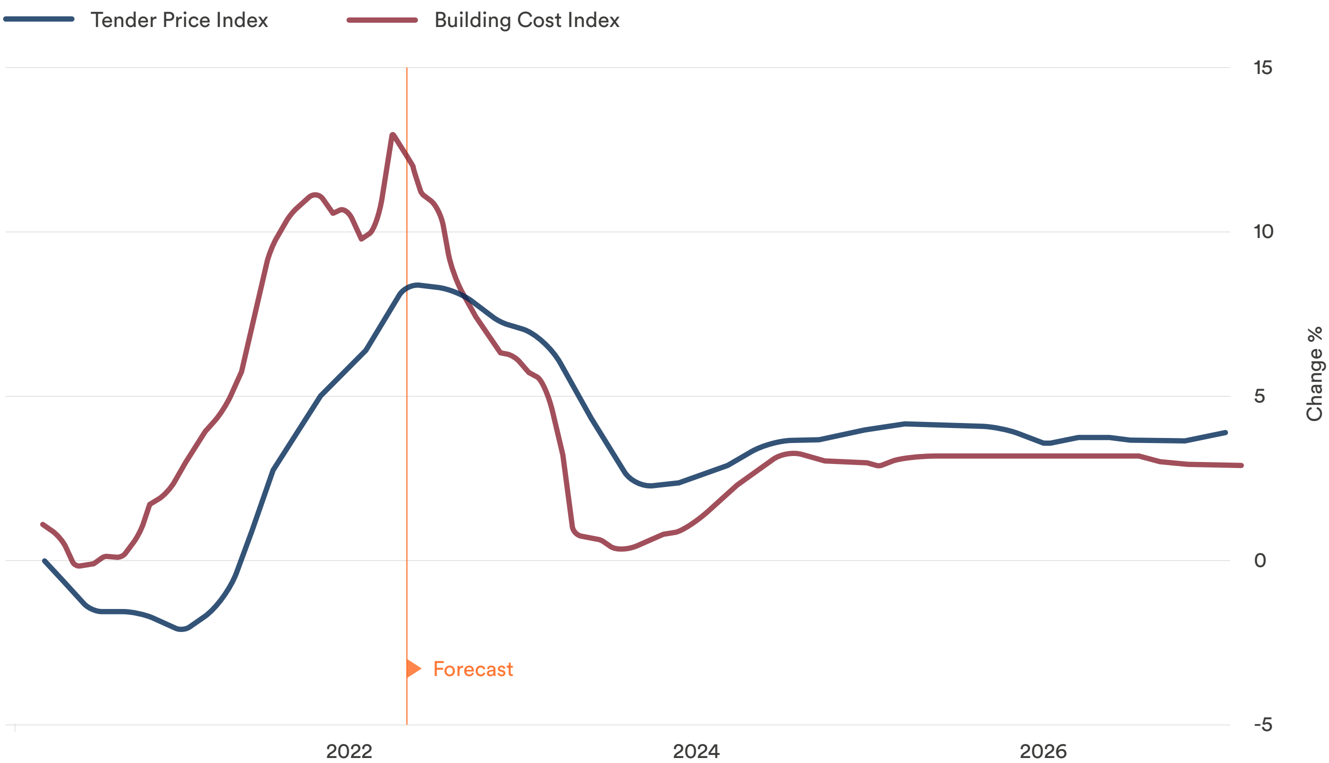
2.2 Building Cost Index

A composite measure of building input costs increased by approximately 9.5% over the year to Q2 2022. Global and domestic supply chain issues, along with improved demand, have contributed to strong inflation trends.

2.3 Consumer Prices Index

The consumer prices index rose by 7.0% in the 12 months to March 2022, the highest rate of change in 30 years. Consumer price inflation is expected to increase further still over the first half of 2022.

Tender Price and Building Cost Index



Data Source: BCIS

2.4 Labour Prices

Labour rates continue to rise steadily, reflecting robust workforce demand, and a very high number of construction vacancies. An aggregate measure of site trades recorded a year-on-year change of 3.2% between Q1 2021 and Q1 2022. This calculation includes some carry-over effects from 2020, so a comparison against a pre-pandemic year sees a 2% increase versus Q4 2019. Wage pressure is not likely to fade, unless there is a significant adverse change in workload trends or output over 2022.

More generally, the rate of change for average earnings across the country is now negative once adjusted for quickly rising consumer price inflation. This will mark the third period in the last decade where earnings adjusted for inflation were falling.

2.5 Tender Price Forecast

Figures published by the Building Cost Information Service (BCIS) indicates a 7.5% increase in tender prices to Q2 2022 compared to the same period the previous year. This can be attributed to the emergence from lock down and the increase demand for material and labour and the increase in energy costs.

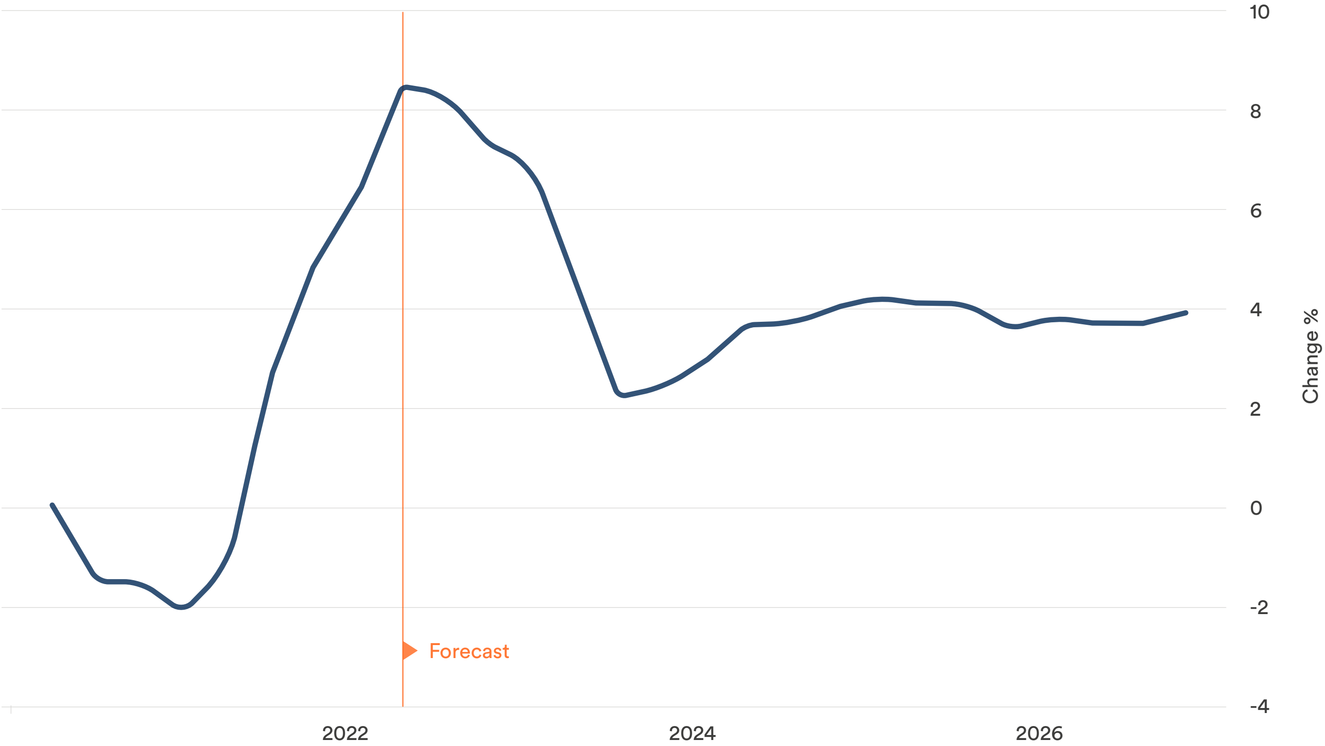
The table on the right presents the forecast inflation from 2022 to 2025 from key consultants within the construction industry and the BCIS TPI indices. This highlights that the industry is expecting tender prices to increase over the next three to four years.

Forecast Inflation

	1Q 2022	1Q 2022	Spring	1Q 2022	4Q 2021	2Q 2022	04/22
Year Ending	G&T*	Aecom	Arcadis	Mace	RLB*	FBR	BCIS
2022	2.5%	7.1%	5.0%	5.5%	3.6%	7.5%	6.4%
2023	2.0%	5.0%	5.0%	3.5%	3.6%	4.5%	4.5%
2024	2.0%	3.5%	5.0%	3.0%	3.5%	4.0%	3.7%
2025	2.0%		5.0%	3.0%		4.0%	4.1%

Pre-Russia invasion of Ukraine

BCIS: All in TPI Indices



Data Source: BCIS

The Construction Market.

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3 The Construction Market.

3.1 Works on Site

The latest data from the Office of National Statistics shows that the Monthly construction output increased by 1.1% in volume terms in January 2022 and is now at its highest level since September 2019; this follows an increase of 2.0% in December 2021 and is the third consecutive monthly growth greater than 1.0%.

The increase in monthly construction output in January 2022 came solely from an increase in repair and maintenance (4.6%) as new work saw a slight decrease of 0.8% on the month.

At the sector level, the main contributors to growth in January 2022 were private housing repair and maintenance and non-housing repair and maintenance, which grew by 5.0% and 5.5%, respectively.

The level of construction output in January 2022 was 1.4% (£197 million) above the February 2020 pre-coronavirus (COVID-19) pandemic level. New work was 2.8% (£267 million) below the February 2020 level, while repair and maintenance work was 9.3% (£464 million) above the February 2020 level.

The recovery to date (since the falls at the start of the coronavirus pandemic) is mixed at a sector level, with infrastructure 37.9% (£709 million) above and private commercial 27.8% (£693 million) below their respective February 2020 levels in January 2022.

Alongside the monthly increase, construction output rose 3.0% in the three months to January 2022; this is the strongest growth in the three-month on three-month series since June 2021 (3.4%), with increases seen in both new work and repair and maintenance (4.0% and 1.4%, respectively).

3.2 Material Availability

As we move through Q2 2022, we are still experiencing long lead times for certain key materials and associated cost premiums. This shortage is set to worsen as the war in Ukraine escalates and energy prices continue to soar. This is particularly the case with energy intensive materials, such as bricks, steel and cement. This could impact costs as the suppliers look to pass on these increased costs through the supply chain.

The UK imports around 200,000m^3 of timber from Russia currently. Due to UK sanctions this supply route has now been significantly reduced. As such, shortages are feeding through the supply chain again, with the associated cost increases.

The Construction Leadership Council (CLC) warned earlier this year that high energy prices would impact on the year ahead. Price inflation could potentially increase from 7-10+%, with multiple increases expected for some products.

Electrical products, particularly those using semi-conductors and microchips could also be subject to longer lead times. The effect of sanctions on Russia could also compound this problem.

The material shortage has not only had an adverse effect on the price of materials, it has also increased the lead in times. Contractors are now facing delays of weeks for products that had previously been available either immediately or within a couple of days. These increased lead in times are creating programme issues for projects that are both on site or about to start. Contractors are reporting that lead in times are moving on a daily basis.

Bricks and Blocks

Challenges exist with the supply of bricks and blocks, the CLC says. Stocks have increased slightly during the quieter winter months but as the market accelerates in the spring it will be important plan ahead and work with manufacturers to ensure timelines of availability.

Steel

At the start of the year Russia and Ukraine together constituted the second largest steel exporter in the world, and shortages on the continent are having a knock-on effect on the UK market.

Roof Tiles

Long lead times remain for both concrete and clay roof tiles, averaging around 20-24 weeks, but can be up to 36 weeks for some products, according to the National Federation of Roofing Contractors (NFRC).

Paints and Coatings

Paints and coatings remain affected by the ongoing raw material shortages, which has recently been exacerbated by further lockdowns in China (due to COVID-19) and by the war in Ukraine. This could possibly affect the availability of some products over the coming months.

Timber

The war in Ukraine and the resulting sanctions on Russia and Belarus are likely to constrain the supply of pallets, birch plywood and OSB (oriented strand board).

There could also be future supply issues with:

- Plastic products
- Ceramic tiles and sanitaryware
- Aluminium
- Copper
- Lighting and fire protection systems
- Kitchen white goods
- Concrete
- Insulation

3.3 Price of Materials

Supplier price rises are set to continue throughout the remainder of the year. The largest reason given by Jewson for their increases is the unprecedented increase in the cost of fuel which, since December 2021 , has increased by over 25%. This increase has been unpredictable to many of our suppliers and has unfortunately caused many to increase their prices at short notice. This is further impacted by the impending removal of the rebate fuel entitlement which came into effect in April (see Section 5).

Other than fuel, price increases continue to rise due to increased costs for raw materials, labour costs, transport, freight, and packaging. Suppliers are also continuing to see the impact of the increase in wholesale energy costs in their overall product production costs which is causing them to increase their prices.

Due to the Russian invasion of Ukraine and the sanctions imposed on Russia, suppliers are unable to source shipments of Birch Plywood from Russia. Birch Plywood mainly comes from Russia, with some also coming from Latvia and Finland. Suppliers have to rely on current stocks and any shipments that have already left and are en route from Russia. Consequently, the price of existing stocks of plywood is rising daily, sometimes by the hour based on demand. Distributors have also confirmed they are unable to obtain shipments from Latvia due to political reasons with shipments from Baltics.

3.4 Plant

The supply of plant to sites is being heavily affected by the HS2 development. This can be seen with regards to the increase in demand for piling rigs. The lead in times has increased from 6 to 10 weeks for some suppliers. Clients are now being asked for Letters of Intent prior to a formal contract being signed in order to secure plant on site.

An Insight into the Energy Market.

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4 An Insight into the Energy Market.

With energy prices on the rise, it's more important than ever to understand why energy markets can be so volatile. They react to a wide range of price drivers, as well as underlying macro-economic factors, all of which are interconnected globally.

For instance, what happens in Asia or North America will influence the overall demand across the globe.

Key Price Drivers

1. **Demand:** Industrial activity, heating in winter, cooling in summer, new usage such as electric vehicles, electrification of transport.

   Natural gas wholesale prices have surged over the past year because of imbalances resulting from excess demand for energy. This has affected Europe and Asia most, with natural gas prices there about ten times those in the US at the end of 2021. Higher demand from Asia's manufacturing sector, and geopolitical factors such as Germany suspending the licencing of the Nord Stream 2 pipeline bringing gas to Europe from Russia, caused energy prices to surge. More recently the invasion of Russia into the Ukraine have roiled natural gas futures markets in Europe and the UK.

Supply: Coal, gas/liquefied natural gas, nuclear output, wind and solar import and export via interconnectors between countries.

The UK draws most of its gas (50%) from the North Sea, with around 30% from Norway, with only 3% coming from Russia, so interruptions in supply would be less likely, but it would suffer from higher wholesale gas prices due to the heavy reliance of Russian gas by Europe.
Compared with other European countries, the UK has very little gas storage capacity, making it more vulnerable to supply interruptions.

The surge in gas prices is feeding into a rapid increase in the cost of living that reduces households' purchasing power at a time when real income growth is being eroded by higher inflation (set to hit 7% in 2022 Q2) and a scheduled rise in payroll taxes.

Monthly average gas prices in Britain have been soaring. Figures from Ofgem showed that the wholesale price of gas through forward delivery contracts jumped 80% in the six months to April 2022, while the price of gas delivered through day-ahead contracts more than trebled. The increase in prices has been fuelled by rises in global energy costs, with everything from lower pipeline supplies of gas, greater imports from China, rebounding economies post-covid, low levels of wind, outages at nuclear power stations and a colder winter being cited as factors. The military conflict in Ukraine has resulted in a significant rise in the price of energy bills.

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Red Diesel.

5 Red Diesel.

Red diesel is the fuel that was intended for use in vehicles that don't use public roads as well as certain types of machinery. Red diesel was taxed at a different rate to white diesel (which is used in cars and other road vehicles), originally, in an attempt to reduce the operating costs of businesses. Red diesel was taxed at 11.14p/l, while white diesel is taxed at 57.95p/l, which is five times higher.

The use of red diesel included tractors, farm vehicles and those used in forestry, horticulture and fish farming. It also included those vehicles used within the construction sector, amendments to the law has now banned this from 1 April 2022. This ban will include it's use in diggers and generators.

The main reasons for this change to the law surrounding rebated fuel is part of the government's attempt reduce carbon emissions and meet air quality targets. This will focus on three main areas:

- Reflect the impact of carbon emissions, by taxing the majority of users at the higher rate
- Promote energy efficiency
- Encourage the use of cleaner fuel alternatives

The red diesel duty rates on fuel had been in place since 2010. Therefore, this change would result in an additional cost of 46.81p/l. All heavy construction vehicles will now be banned from using red diesel, which will have a material impact on the running costs of these vehicles moving forward. Red diesel is also being banned for use in power generators, which are often used to run construction sites.

This is not the only issue facing the construction industry in order for companies to become compliant with the new laws before the deadline. Other issues include one-off purchases, removing or running down existing red diesel, and additional tanks and equipment. This is likely to cause a knock-on effect, with construction prices continuing to rise.

Although, it is important for the construction industry to be increasingly sustainable and environmentally aware, the development of electric plant and alternative fuels was impacted by the pandemic, slowing its progress. This, on top of lingering COVID-19 issues, conflict between Russia and Ukraine as well as the increase in oil and gas prices will place increased pressure on rising prices.

Advice & Recommendations.

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The main issue affect the construction industry is the spiralling inflation, this has come quickly on the back of the impacts of COVID-19, the current war in Ukraine and the UK leaving the European Union. It has been quiet the perfect storm for the construction industry.

Whilst there are currently inflationary issues within the construction industry leading to higher costs and programme issues, there are mitigation measures that can be applied in order to minimise the effect to projects.

- Clients should consider allowing time within the project programme for longer mobilisation periods to account for longer lead in times in order to mitigate delays during construction.
- Clients should consider early order of building materials with particularly long lead in times and those which have a great price sensitivity.
- Greater collaboration with contractors in order to manage risk and ensure sufficient financial allowances and lead in times are made.
- Allowing for early order of materials in construction contracts to minimise the risk of sudden increase in prices and make sure that contract conditions include are sufficient to allow purchase of materials off site.

It is also worth considering fluctuation provisions. These may not be appropriate for all projects and the risk mechanism must be measured considerately. Delays in the supply of materials and labour together with the fluctuating cost of these are risks generally borne by the contractor. Fluctuations will always be present, but current events have the potential to create unpredictable variations in material prices and labour costs. However, the present challenge is that these are not manageable leading to the contractor either pricing significant risk premiums within a fixed price contract sum to carry these risks or being unwilling to take on these risks completely through the tendering process. This can lead to inflated tender prices or can create post contract issues where the premium is still inadequate.

Building contracts include fluctuation provisions to account for such risks between the client and contractor. The choice of fluctuation provisions should be determined by the application of a risk assessment in order that the risk sits with the party best placed to quantify, manage and bear such risks with provisions included that are fair and reasonable to both client and contractor. Further information can be sought from the RICS guidance note on Fluctuations available on their website.

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