Fulkers Bailey Russell

Construction Market Report

November 2022 Q4

Fulkers
Bailey
Russell

Big enough to cut it,
small enough to care.

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Executive Summary.

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1 Executive Summary

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 wider economy has been experiencing a great deal of turbulence over the past number of months. We have had three prime ministers and three chancellors since our last report. This comes on back of the UK leaving the European Union via Brexit, the pandemic caused by COVID-19, spiralling energy costs, the war in Ukraine. Now we are faced with inflationary cost pressures coupled with rising interest rates which is being used as a mechanism to curb inflation.

Whilst contractors are currently busy, they are anticipating a slow down in opportunities next year. Contractors are also indicating that inflation is impacting profit margins and growth.

UK inflation hit a 41 year high in October when it reached 11.1%. This has increased from 10.1% in the 12 months to September. The Bank of England are predicting that inflation will remain at circa 11% for a number of months before coming down. The Bank of England target rate for inflation is 2%, so there is some way to go.

We can expect interest rates to increase further as the Bank of England looks to curb the inflation rate. The Bank of England raised interest rates to 3% in November 2022. This is the highest rate in 14 years. Higher interest rates make borrowing more expensive, encourages saving, and reduces how much people spend overall. Interest rates are now 11% higher than they were in September and 60% higher than they were this time last year. Interest rate rises are not a quick fix for reducing inflation, and it will take some time for the increase in interest rates to be effective and for inflation to start to fall.

The ongoing energy crisis is continuing to contribute to increasing energy prices, however, energy prices have been falling due to an increase in liquefied natural gas supply and low demand amid unusually warm autumn weather. This has allowed some European countries to replenish their gas stocks, this has reduced concerns and has led to a drop in wholesale gas prices over the last two months. However, as demand increases over the winter months, we can expect the wholesale gas and oil prices to start rising again.

The Bank of England is also anticipating a recession next year. The UK economy contracted 0.2% in the third quarter of 2022 according to latest GDP figures. A further consecutive quarter of decline in the three months to December would indicate that the UK is in a technical recession and this could lead to a period of Stagflation as reported in our last edition of our Construction Market Report and is further detailed below.

Inflation Review.

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2 Inflation Review.

2.1 Tender Price Index

Tender prices increased by almost 10% over the 12 months to Q4 2022. Price inflation trends will continue to plot an upward course into 2023, due to a combination of supply-side problems and construction output momentum combine.

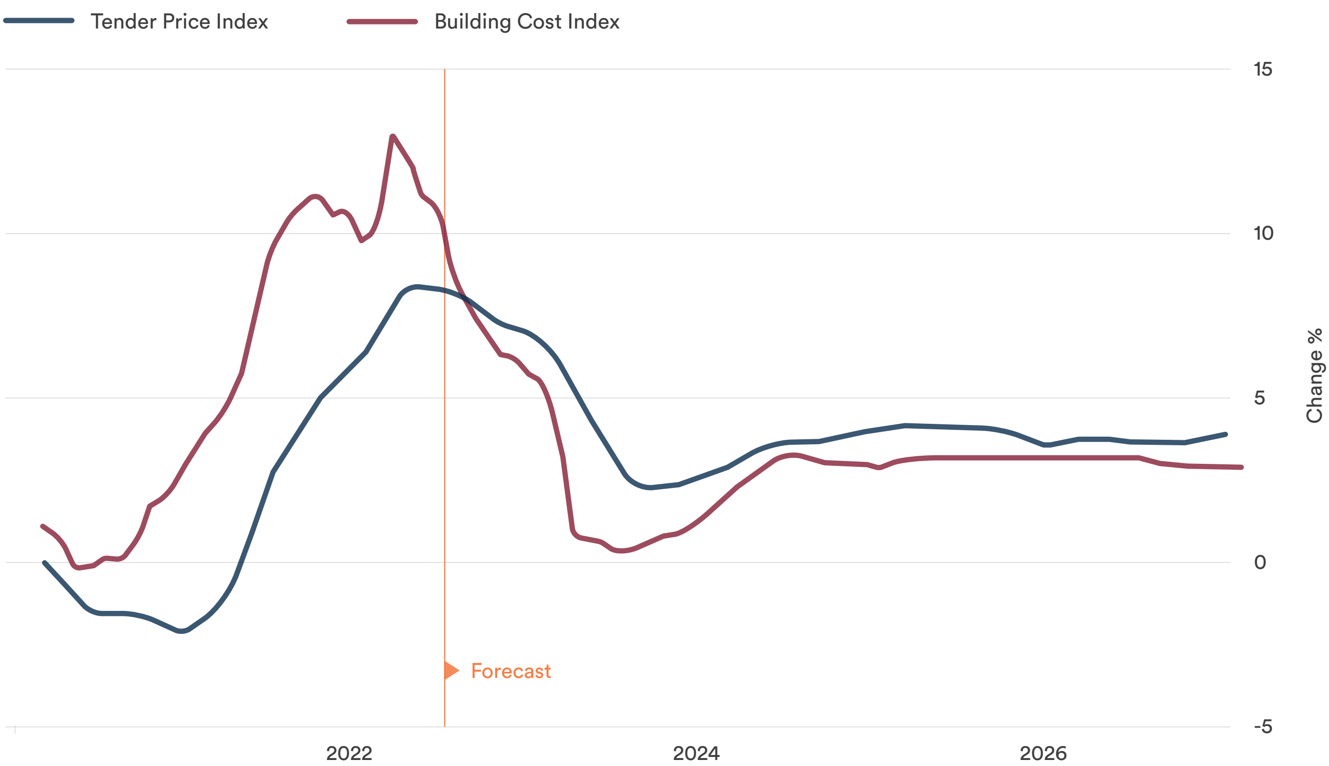
2.3 Consumer Prices Index

The consumer prices index rose by 10.1% in the 12 months to November 2022. UK inflation has only exceeded 10% on a yearly change basis three times in the last 70 years.

2.2 Building Cost Index

A composite measure of building input costs increased by just over 9% over the year to November. This is still an elevated level of input cost inflation, although rising at a slower rate.

Tender Price and Building Cost Index



Data Source: BCIS

2.4 Tender Price Forecast

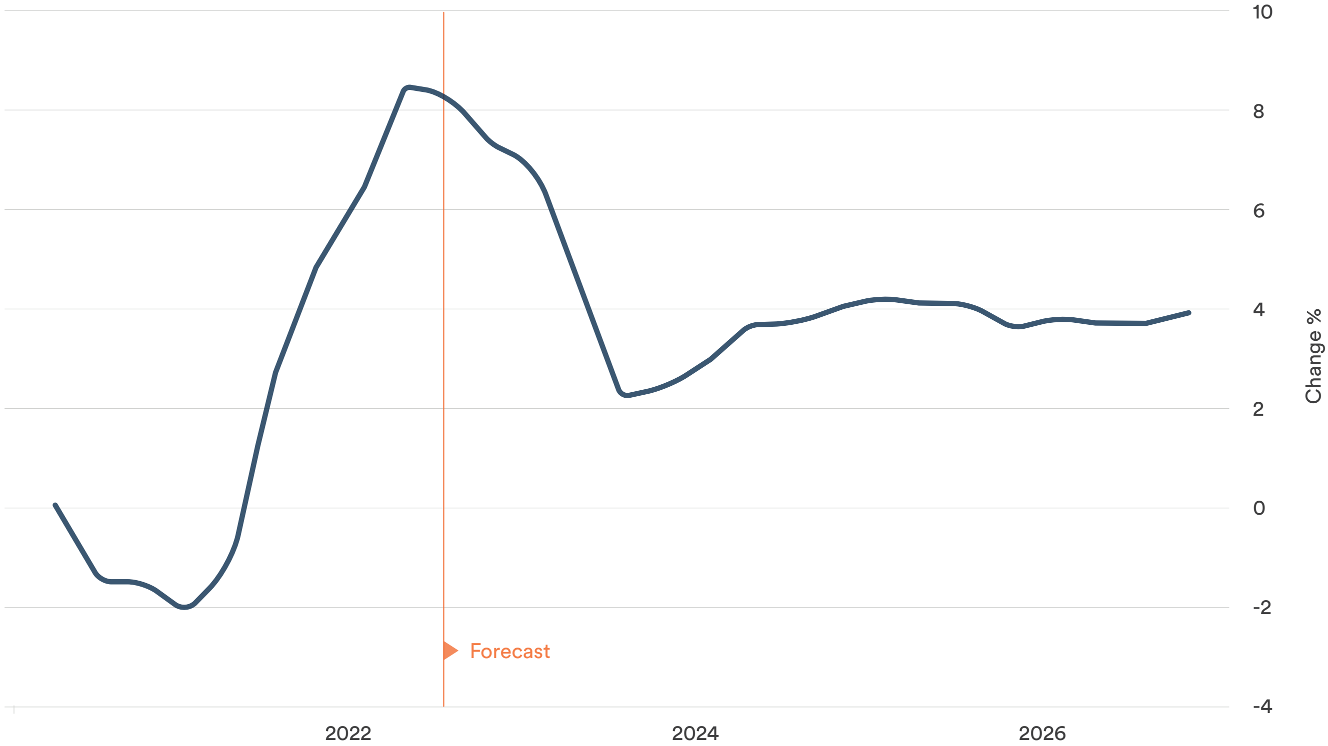
The issues facing the construction industry are very likely to continue into 2023. These issues are joined by the added complexity of higher borrowing costs working through into public sector, private domestic and private sector new orders and future pipeline.

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 years.

Forecast Inflation

Year Ending	4Q 2022 G&T	3Q 2022 Aecom	Autumn Arcadis	3Q 2022 Mace	4Q 2022 Fulkers	10/22 BCIS	Average
2022	5.5%	8.4%	10.0%	8.0%	8.5%	7.8%	8.0%
2023	3.0%	6.2%	2.5%	3.5%	7.0%	6.2%	4.7%
2024	2.5%	4.2%	3.0%	2.0%	4.0%	3.3%	3.1%
2025	2.25%		3.0%	2.0%	3.5%	3.4%	2.8%

BCIS: All in TPI Indices



Data Source: BCIS

The Construction Market.

3

3 The Construction Market.

3.1 Works on Site

Monthly construction output increased 0.4% in volume terms in September 2022. This is the third consecutive monthly growth following small upward movements nameley 0.6% in August 2022 and 0.2% in July. September 2022 showed the highest level of construction output (£15,125 million) since records began in January 2010.

The increase in monthly construction output in September 2022 came from increases seen in both new work (0.6%) and repair and maintenance (0.2%) on the month.

At the sector level, 5 out of the 9 sectors saw an increase in output in September 2022. The main contributers being the monthly increase seen in public housing repair and maintenance and infrastructure new work, which increased 11.3% and 2.8% respectively.

The level of construction output in September 2022 was 4.0% (£575 million) above the February 2020 pre-coronavirus (COVID-19) pandemic level. New work was 0.3% (£29 million) below its February 2020 level, while repair and maintenance work was 12.0% (£604 million) above the February 2020 level.

Alongside the monthly increase, construction output saw an increase of 0.6% in Q3 (July to Sept) 2022, although this is the weakest quarterly growth since Q3 2021 (1.1% fall). The increase came solely from growth in new work (2.4%) as repair and maintenance saw a decrease (2.2% fall).

Total construction new orders increased 6.4% (£774 million) in Quarter 3 2022 compared with Q2 (Apr to Jun) 2022. This quarterly growth came mainly from private commercial new orders, which rose 27.7% (£832 million).

The annual rate of construction output price growth was 10.1% in the 12 months to September 2022. This has slowed slightly from the record annual price growth in May 2022 (11.5%).

3.2 Price of Materials

Across all industries, input costs have increased on average by nearly 30% which has resulted in increased input prices across the board.

The CLC warned to expect further inflation for energy intensive products such as insulation, cement, concrete and steel. The statement raised concern that price volatility had led to the failure of relevant indices to reflect market reality.

Steelwork rates are still increasing in the market. This increase is the result of a number of factors including lower output of iron ore in Brazil and larger than usual demand both from China and Europe.

The broader impact of the crisis will be felt through high energy costs. Europe has few short-term options to increase the supply of gas and petroleum products from sources other than Russia. This means that construction material prices are likely to remain at or near record levels for some time to come.

Until the capacity of supply chains is restored and energy prices stabilise, material prices are likely to increase in the short term.

Category	Manufacturer	Products Affected	Price Increase	Effective From
Insulation	Kingspan	Therma PIR	10%	5th December 2022
		Kooltherm Pipe Section Insulation	15%	
	Xtratherm	PIR Product Range	TBC	1st December 2022
Drylining and Plasters	Celotex	All Products	14%	1st December 2022
Ceilings	Zentia	All ceiling tiles (except Tatra, Cortega, Fine Fissured, Mezzanine, Merit and Diploma)	3%	1st December 2022
		Tatra, Cortega, Fine Fissured, Mezzanine, Merit and Diploma	10%	
Roofing	Cembrit	All Products	8%	1st November 2022
Ceilings	Rockfon	Tiles, Islands, Baffles & Wall Panels	9%	1st November 2022
Insulation	Kingspan	Therma PIR	10%	1st November 2022
	Cellecta	All Screedboard branded products, All HiDeck branded products & All other gypsum-based products	8%	3rd October 2022
	Actis	All Products excl Hcontrol Hybrid +	7%	1st October 2022
		Hcontrol Hybrid+	2%	
	Xtratherm	PIR Range	10%	1st October 2022
Drylining & Plasters	Celotex	All Products	10%	1st October 2022
	Euroform	Fixings	10%	1st October 2022
Ceilings	Sektor	Grids	7.5%	1st October 2022

The impact of the energy crisis on materials is also still being keenly felt by the industry. Brick and concrete prices are set to rise again:

- Ibstock will be going to the market with a 28% increase in November, which although it includes the previous 8.5% surcharge, still means since 1st January their brick costs will have increased by 42%.

- Forterra have confirmed a 15.5% increase this month, meaning since 1st January their brick costs will have increased by 53%.

- Wienerberger have advised that their bricks will increase by 18.9% from the 5th of December, meaning since 1st January their brick costs will have increased by 41%.

- Michelmersh have confirmed that from 1st January they will be applying a price increase of 16% across their UK brands and their Belgium brand will have a 20% increase applied, meaning since 1st January their brick costs will have increased by circa 30%.

increase in the short term.

An Insight into the Energy Market.

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4 The Energy Market.

4.1 The Energy Market

This year, the cost of living crisis, including a spike in gas prices as a result of Russia's invasion of Ukraine, has prompted a surge in the number of households struggling to afford heat and electricity. In October 2022, an estimated 4 million households in the UK were in fuel poverty.

Gas prices in the UK have tracked European prices lower since late summer, with the month-ahead prices falling from more than 600p per therm in August to less than 200p per therm in October 2022, though they have now risen back to more than 300p per therm. To bring some context to the current pricing levels, pre-crisis averages were about 50p per therm. However, the warm weather in this quarter brought a unseasonably reduction in demand for gas.

The long-term solutions to the energy crisis include energy market reform boosting UK energy supplies with new renewables, nuclear and domestic gas production and storage, and by cutting demand through improving insulation in existing and new properties.

While welcoming these steps, construction trade bodies have called on the government to go further with decisive action to improve the energy efficiency of UK homes – arguing short-term help with energy costs would not be enough for the industry and smaller contractors.

With decisive action to improve the energy efficiency of UK homes – arguing short-term help with energy costs would not be enough for the industry and smaller contractors.

Despite the UK government's announcement of a six-month energy price cap, risks around supply and cost of energy pose a threat to manufacturing throughout the continent.

While EU policymakers wrestle with their own solutions, the possibility of factory shutdowns on the continent may lead to shortages of products, materials and components exported to the UK.

The Energy Prices Bill, introduced in Parliament on 12 October 2022, provides the legislative footing needed to ensure that people and businesses across the UK receive support with their energy bills this winter through the Energy Price Guarantee for domestic consumer, and Energy Bill Relief Scheme for businesses and non-domestic properties.

The Bill will run for six months, with a review after three months to consider whether it should be extended or whether specific sectors require more targeted support.

Experts believe a serious energy-efficiency programme could have a real impact within a year. The institute pointed to Germany as a success story where grants, low-interest loans, tax rebates and free expert advice have all been used, resulting in high take-up figures.

So in summary, the impact of energy prices is still being felt in the construction industry and on the wider population as well, with increased prices across the board. The price cap is a sticking plaster which will help in the very short term, but long term solutions will be required and is something which companies will need to start engaging with, assisted by the construction industry as a whole.

Rising Interest Rates & The Effect On The Construction Industry.

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5 Rising Interest Rates & The Effect On The Construction Industry.

The Bank of England has advised that the rapid increase in the cost of living due to higher energy prices and increased prices of food and other goods has caused the rate of inflation to rise.

In order to bring inflation back down to ensure that it is low and stable, the Bank of England need to increase the interest rates. This was demonstrated by the 0.75% interest rate rise in October from 2.2 need to 5% to 3%.

The increased interest rates and heightened inflation rates may have a negative effect on the construction industry for the following reasons:

- The cost of construction materials will have become more expensive, causing a knock-on effect throughout the supply chain from manufacturing to the end user. This will reduce the profit margin on projects and potentially halt new developments.
- Increased interest rates can lead to lower demand in the housing market. As the cost of mortgages increases, people are less likely to buy new homes. Affects new and existing stock.
- Cashflow within construction companies is extremely important and they may need to borrow money to fund new developments or subsidise late payments. As a result of interest rate rises, borrowing becomes more expensive having a negative impact on profit margins. Some companies will stop investing in developments resulting in decreased construction growth.

All of the above have a negative effect on the construction industry and in turn could lower economic growth of the sector.

Insolvency.

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6 Insolvency.

6.1 Insolvency

In terms of the construction industry, over 70% of construction companies have made changes to counter rising energy bills with 15% of these describing the change as ‘radical’ according to Ayming’s fourth International Innovation Barometer. The energy crisis has companies looking for new ways to save money and keep innovating. Despite this however, close to 17,000 construction-related businesses are at “significant risk” of insolvency, research suggests.

Spiralling construction costs coupled with high inflation and rising interest rates on debt have contributed to a 54% hike in the number of firms that are financially stressed, data from tax advisory firm Mazars has found.

Construction Products Association economics director Noble Francis stated that smaller firms would be hit the hardest by any issues with energy this winter. However, he was optimistic that the measures introduced by the government could help to shield SMEs.

Falling Pound and Market Pressure.

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7 Falling Pound and Market Pressure.

7.1 Falling Pound and Market Pressure

The former Chancellor Kwasi Kwarteng's fiscal statement on 23rd September 2022 saw the pound slump to all time lows against the dollar ($1.03). The sweeping tax cuts announced by the then Chancellor announced led to a steep fall in the pound in addition to the Chancellor's high borrows growth plan which spooked the markets.

A sudden and sharp drop in the pound creates uncertainty, throwing the plans of UK businesses that import and export goods into disarray. They expect to pay a specific sum for imports and get a certain price for goods and services they sell abroad. All that changes when the currency falls. In simple terms if the pound is worth less, the cost of importing goods from overseas goes up.

Oil is one of the key commodities Britain imports and it is priced on international commodity markets in dollars. A weak pound will make filling up your car with diesel or petrol more expensive. Gas is also priced in dollars. The UK also imports 50% of its food, so the cost of daily products will increase due to increased transportation costs.

The Road to Recovery

The recent appointment of Rishi Sunak as Prime Minister presents some upsides for the UK economic outlook. There has been an U-turn on the September 'mini budget' tax cuts. One of the most significant of these was reversals of the planned rise in corporation tax next April. The prospect of a more 'prudent' approach to public finances is probably one factor behind the favourable market reaction to the new Prime Minister's appointment.

Advice & Recommendations.

8

8 Advice & Recommendations.

8.1 Advice & Recommendations

The main issue affecting the construction industry is the spiralling inflation and a looming recession. 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 quite 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 on projects.

Clients could:

- Consider expedited design programmes in order to get to site more promptly. But costs are high, they could consider make good and mend rather than accelerate new builds.
- Collaborate more with contractors in order to manage risk and ensure sufficient financial allowances and lead in times are made.

• Allow 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.

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.

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 if the premium proves to be 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. The provisions included should be fair and reasonable to both client and contractor

It may be worth considering an inflationary allowance within the overall construction costs. This pot could be used if it is demonstrated that the cost of a particular trade or material has increased significantly since the tender period. The team at Fulkers Bailey Russell will be happy to discuss this further with you.

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