Construction activity and market outlook

United Kingdom - Q1 2019

It had been hoped that we might now have received some clarity on the UK's relationship with the EU. At the time of writing, however, the government has had to accept a further extension to the implementation of Article 50 to 31 October 2019. Parliament shows no signs of finding a consensus on a way forward and technically, at least, a no-deal Brexit is also still a real possibility.

Overall, the UK economy has lost some momentum, and much of this must be a consequence of the Brexit uncertainties. In the UK, GDP grew by 0.2% in the three months to January 2019, and by 1.4% in the year. According to the ONS, house prices are also rising at their slowest rate for almost six years. Construction output did grow by 2.8% month-on-month in January, having fallen by 0.6% in the preceding three-month period. However, the rapid post-recession growth experienced in construction since 2012 does appear to have now tailed off. The main drivers for the output we are seeing generally remain private new housing and repair and maintenance, but new orders fell by 1.9% in Q4 2018. The impact of this on industry sentiment is reflected in the latest IHS Markit/UK Construction Total Construction Activity Index for February 2019 which was 49.5, down from 50.6 in the previous month (50 is the neutral position).

The chancellor's spring statement may have provided some positive news with a £26.6 billion budget being set aside to boost the economy post-Brexit, but the timing of this being released is contingent upon a deal being reached.

There is currently a growing body of economic opinion that a global recession may be on the horizon, based variously on reasons of cyclical analysis or because of data from certain key investment indicators which have often presaged a downturn. This view is by no means universal. Clearly, there are signs of slowdown in both USA and China economies, not helped by the ongoing trade wars, and some EU economies remain weak; Germany is on the cusp of a technical recession. Our analysis, however, is that while these global headwinds may contribute to a prolonged downturn in the UK, we are currently not factoring in a full-blown recession. The OBR forecast is for GDP growth to remain at 1.4% for 2020 and 2021, and 1.5% in 2022.

CPI has fallen to 1.9% from 2.1% in the last quarter. This closer alignment with the Bank of England's 2.0% target threshold may hold off a further base rate rise for the foreseeable future and underpins the view of many forecasters that CPI should stay at around 2.0% over the next four years. Treasury analysis forecasts that CPI will remain at around 2.0% pa over our forecasting period.

Sterling remains comparatively weak, but interestingly has rallied lately, or at least has not reacted adversely against the day-to-day tribulations in Parliament. Against the dollar, sterling is now $1.32, having recovered from a near two-year low in December of $1.27. Against the euro, sterling is now €1.17, up from a low of €1.10 at year-end.

Currie & Brown's UK TPI forecasts continue to assume a 'soft' Brexit scenario. As previously, our analysis is based upon flat construction growth through this year and next, before seeing increased rates of growth from 2021. Our TPI forecasts broadly stay in line with CPI forecasts, with a UK-wide TPI of 2.1% this year, progressively rising to 3.0% in 2023. We have made slight upward adjustments at the start of the forecast period to reflect the impact of input cost pressures.

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Materials and commodities costs:

The BCIS Materials Cost Index grew 3.3% in the year to December 2018, a slight easing on earlier figures. The forecast is to remain between 3.0% and 4.0% going forward. [BCIS]

Labour costs:

The unemployment rate continues to fall and is now 3.9%. Employment in construction also remained stable to year-end. Average weekly earnings in construction increased by 3.9% in the year to Q4 2018, 0.5% above the rate for the wider economy of 3.4%. [ONS]

Inflation:

CPI has fallen again to 1.9%, down from 3.0% at the start of 2018. [ONS] This broad return towards the Bank of England's 2.0% benchmark may hold off a further base rate rise, which was kept at 0.75% in February. [Bank of England]

Insolvencies:

In 2018, construction had a higher insolvency rate than any other industry, with around 2,900 companies defaulting. This is an increase of 12.0% on 2017 and the highest level since after the recession in 2013. [ONS]

GDP:

UK GDP grew by 0.2% in the three months to January 2019, and by 1.4% in the year. [ONS]

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As we now pass the original planned EU exit date, it is worth reflecting that the construction industry has shown remarkable resilience in the face of economic headwinds that have been totally dominated by Brexit. With no greater clarity in sight, however, business is now becoming increasingly frustrated with the lack of progress, and investment has stagnated. ONS analysis suggests that investment is 10.0% lower now than it otherwise might have been without this level of uncertainty. It is difficult to believe that Brexit is not at least a contributory factor in the recent announcements from major motor industry manufacturers in scaling back investment plans and some notable product manufacturers planning company relocations to Europe or Asia.

The construction market is clearly softening, and it is likely to be quite flat through 2019 and 2020. The relationship between construction output and GDP growth is an interesting one and we should pay close attention to this. The OBR's forecasts for GDP growth of around 2.0% pa, also in line with CPI expectations, looks to be the likely future profile for construction, if a sudden correction arising from a no-deal Brexit or other such event is avoided.

Investor caution seems to be particularly evident in London, but in some other UK cities a different picture is emerging. Demand in London remains high but in terms of rate of growth several other locations are running at a higher rate and arguably seeing higher levels of price inflation. Notably, these are Greater Manchester, where build-to-rent is a strong sector, Bristol, Birmingham and Scotland. The South West market is operating in the shadow of Hinkley C, with its requirement for over 3,000 on-site operatives, but is also seeing some resurgence in private commercial development, which had previously been dormant. Birmingham is showing pre-recession levels of activity, with plans for major commercial-led city centre redevelopment, expansion of the higher education sector and preparations for the 2022 Commonwealth Games. Scotland's activity is generally stable, but tender prices are being influenced significantly by consolidation in the contracting supply chain, and the attitude of the supply chain to perceived risk. Across the board, output is still dominated by residential-led projects and infrastructure. Looking ahead, we see this continuing with private commercial developments potentially coming back into play in the second half of the forecasting period.

The industry is still experiencing ongoing upward input cost pressures; particularly in mechanical and electrical services, which have been quite exposed to supply chain consolidation, labour availability constraints and price inflation on imported materials. Generally, materials and labour cost increases are outstripping tender prices, which, evidence suggests, are getting more competitive as contractors seek to secure pipeline orders from the end of this year onwards.

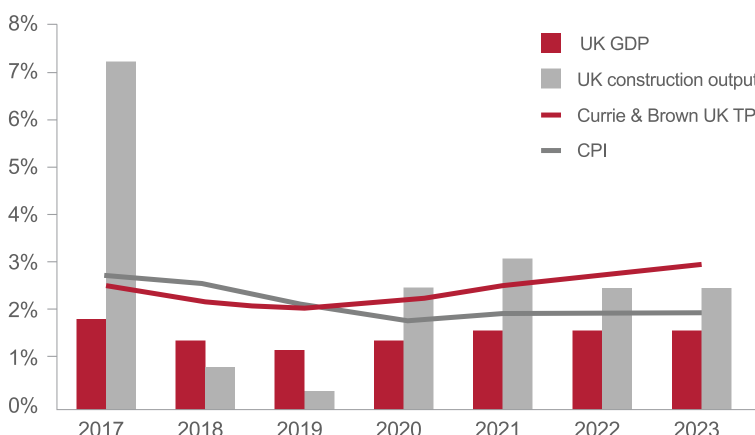
Order books for the larger contractors do appear reasonably good up to Q1 2020, but are much less certain after that. Price competition among smaller contractors is increasing, and there is some evidence of contraction in some early trades. Resources remain tight, but we have not yet seen a significant Brexit jolt. This may have greater impact in the longer term. Interest continues to grow around the use of modularisation in projects, but without a consistency of approach the present rate of delivery is limited. Two-stage design and build procurement is still prevailing on larger projects, but several organisations are also exploring the use of construction management as a means of overcoming concerns around main contractor insolvency. Single-stage procurement is becoming a more favoured option on smaller projects.

UK tender price inflation by region (%)

Region	2018	2019	2020	2021	2022	2023
East Anglia	1.8	1.4	1.5	1.8	2.0	2.0
East Midlands	2.3	2.1	2.3	2.3	2.4	2.5
West Midlands	2.6	2.4	2.3	2.3	2.7	3.0
North East	1.4	1.6	1.8	2.1	2.2	2.3
Yorkshire and Humber	2.2	2.1	2.2	2.5	2.5	2.5
North West	2.3	2.0	2.0	2.4	2.7	2.8
Northern Ireland	1.2	1.2	1.5	2.0	2.0	2.1
Scotland	1.8	2.5	2.4	2.3	2.3	2.5
Central London	2.9	2.4	2.7	3.4	3.6	4.0
South East	2.1	1.7	2.4	2.8	3.0	3.0
South West	2.4	2.5	2.5	2.5	3.2	3.4
Wales	1.2	1.2	1.7	1.8	2.1	2.1
UK weighted average	**2.2**	**2.1**	**2.3**	**2.6**	**2.8**	**3.0**

Our forecast provides guidance on the general level of tender price inflation, based on major and medium-sized projects across all sectors of the market. Project-specific commercial factors can have a significant impact on the level of pricing - size of scheme, attractiveness of scheme (eg complexity, location, risk, etc), procurement route (eg single-stage, two-stage, negotiated) and keenness of tenderers (eg local market dynamics, workloads, hot spots, realisable margins, etc).

Annual UK tender price inflation (%)



How to reduce the risk of contractor default

Insolvency in construction is a fact of life. Companies operate in a high-risk environment at often quite low margins, which can generate issues if problems arise on a difficult site, or the economic environment changes. A contractor default anywhere along the supply chain can cause disruption, additional costs and/or the risk of other parties in the supply chain failing to receive monies due for works carried out or services provided.

If the collapse of Carillion in January 2018 shook the construction industry, the more recent announcement of Interserve being put into administration, following on from a series of restructuring and refinancing measures implemented by other major contractors over the past few years, has left organisations with nervousness and uncertainty in how best to approach the procurement of delivery partners for large-scale construction projects to mitigate against the risk of contractor default.

In both cases, Carillion and Interserve represented large-scale multifaceted businesses that diverted away from pure construction into facilities management and support services, and in Interserve's case into the development of leading-edge waste to energy projects. It could be said that such diversity raises the risk of a company being stretched too thinly. It is undeniable, however, that delays and cancellations to key construction projects, often carrying a higher than normal degree of risk, were a major factor in both companies running up unsustainable levels of debt. Carillion's problems, for instance, focused on three particularly troubled and delayed projects: The Midland Metropolitan Hospital in Sandwell, the Royal Liverpool Hospital and the Aberdeen bypass, accounting for a total of almost £1.5 billion of construction work.

It would be wrong to assume that the risk of contractor default is exclusive to, or even highest with, the multinationals. It is inevitably the big names that command the headlines, but it is the myriad of smaller companies that make up the supply chain that are often the most exposed when faced with difficult economic times.

As data from the ONS's construction statistics report for 2018 sets out, the value of new construction work rose strongly from 2011 to reach record levels of output by 2017. The number of construction companies similarly increased, and by 2017 there were almost 315,000 construction companies operating across the country. As a sign of how precarious our industry is though, the number of insolvencies also grew. In 2018 construction had a higher insolvency rate than any other industry, with over 2,900 companies defaulting. This was an increase of 12.0% in 2017, the highest level since after the recession in 2013. This is perhaps an unsurprising statistic at a time when weaker demand and rising input costs continue to put pressure on margins.

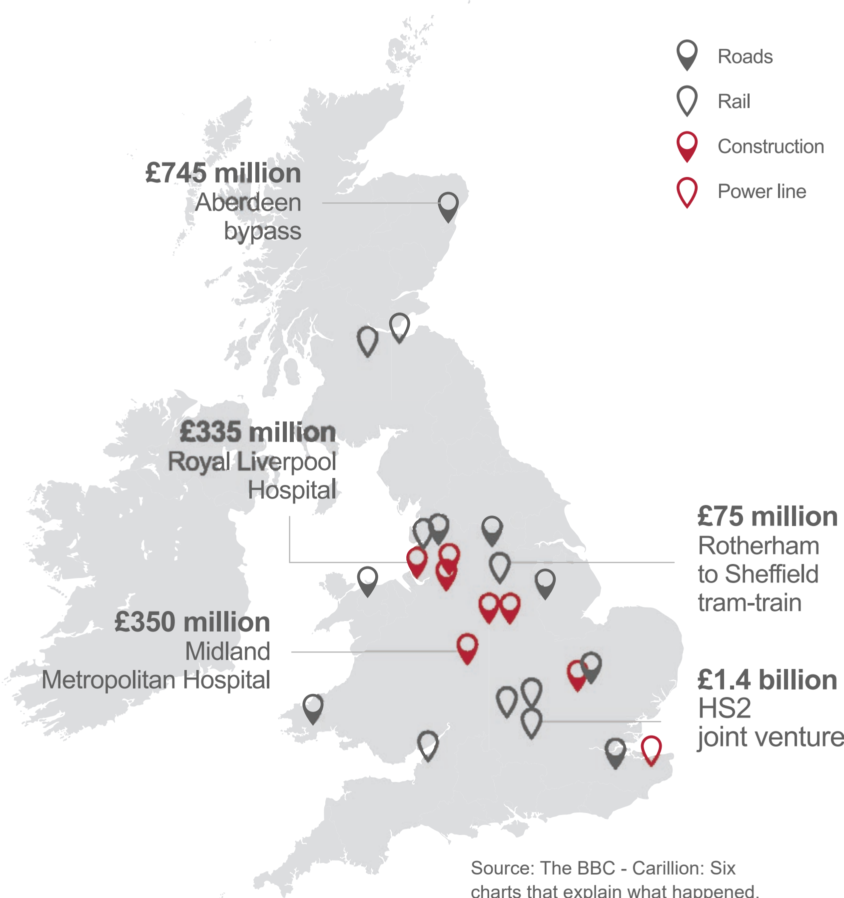
When a contractor becomes insolvent mid-project, the disruption can be significant specifically to that project. However, when a main contractor fails, the impact throughout the supply chain can be much more widespread and extend into the industry itself.

Fortunately, Interserve will continue to trade and operate its existing contracts which former shareholders emphasised in the press. However, it is vitally important to stress, in these difficult times, that organisations engaging contractors need to remain vigilant for the warning signs of contractor insolvency and have a clear strategy to deal with insolvency events before they materialise.

This article offers some thoughts as to how we can work to mitigate against the risk of a contractor default occurring in the first place. What are the problems that might precipitate a contractor default? What are the warning signs? What measures can an organisation or a main contractor put in place to guard against this significant risk?

The Midland Metropolitan Hospital

Carillion's major construction projects across the UK



Source: The BBC - Carillion: Six charts that explain what happened.

What to look for

It is very difficult to get an accurate real-time assessment of a company's financial health. It is important to avoid spreading unfounded rumours or giving the impression that a company is in trouble as this could become a self-fulfilling prophecy that has a detrimental effect on the company concerned, whether it is true or not. However, there are steps that can be taken, whether when selecting suitable companies for a tender's shortlist or when trying to anticipate problems that might arise on a live project.

Published financial accounts or independent credit ratings are useful, but are clearly current at a point in time and tend to look backwards on past performance. They should be used as a guide only. Failure to file accounts on time, on the other hand, could be a significant indicator. Information is available through a variety of sources, formal and informal, including searches of the public registers at Companies House, at the courts or through credit agencies.

Information about companies can be gleaned from the press. In the year before its collapse, Carillion issued three profit warnings in five months and wrote off more than £1 billion from the value of contracts. Several high-profile difficulties were reported on key projects. At Carillion's Royal Liverpool Hospital project, the media reported on the presence of extensive asbestos and cracks in concrete beams, leading to delays which were a key reason for the initial profit warning.

If we are looking at a public company, abnormal movements in share price or an announcement of a large-scale company restructuring may indicate issues of concern, which soundings from colleagues could confirm or refute. Unusual procurement methods, such as breaking packages down into uncharacteristically small parcels could be symptomatic of pressures to cut costs. There might be rumours of delayed payments or of supply chain parties being forced to sign up to excessively long or onerous payment terms. In extremis, reports of problems on other sites such as instances of fires or water damage could be signs of disputes indicating payment issues.

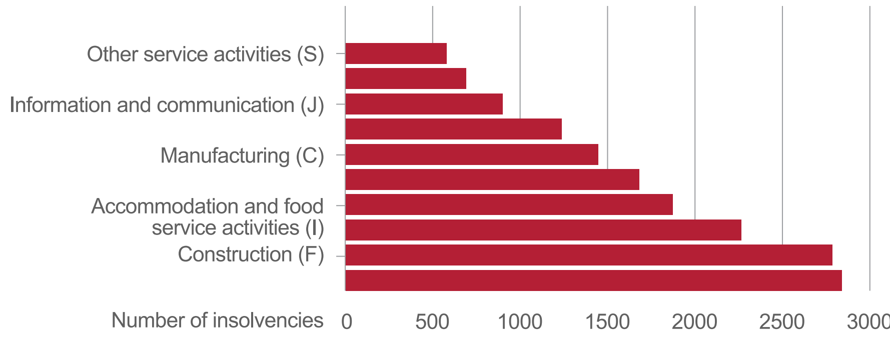
When monitoring a live project, attention should be kept on issues such as:

- A deterioration in performance, whether in terms of day-to-day communications or in the work itself on site.
- A significant drop-off in progress against cashflow.
- An unusually high turnover of staff.
- Pressure to deviate from the normal payment regime. For instance, invoices being pushed through progressively early, abnormally inflated requests for payment, or the supply chain chasing for direct payment.
- Requests for deposits or advance payment.

Any of these could be early warning signs of a company in financial difficulty.

Total new company insolvencies in 2017 by the highest ten UK SIC 2007 sections

(Section in brackets), non-seasonally adjusted, Great Britain



Source: The Insolvency Service – Insolvency statistics: Industry breakdown.

What measures can an organisation take to reduce the risk of exposure to contractor default?

Many of the measures that a commissioning party can take to help lessen the risk of exposure to contractor default are really an extension of the evidence gathering, which we have noted in this feature.

Prior to entering into a tender or a contract arrangement, it is prudent to carry out thorough financial due diligence checks.

If one has had a close working relationship previously with the company concerned it may be possible to have an open discussion about any concerns. This may be all that is required to eliminate any fears.

Preferred key contractors and suppliers should be regularly audited, and subject to ongoing risk assessment.

When entering into a building contract, it is important to make sure that issues such as ownership of materials, payment and performance security are appropriately robust, and that any relevant parent company guarantees, performance bonds and warranties have been agreed and are in place.

It is vital to check that all necessary insurances are in place and that arrangements for the security and protection of the site and materials are robust.

Many established organisations are taking a proactive stance and using the building contract to help mitigate likely pressure points. For instance, the insertion of specific clauses setting out the regime to be adhered to regarding payment periods to the supply chain. Currently, this is certainly a key focus of attention by MPs. Late last year a parliamentary committee report accused the construction industry of having a particularly poor reputation when it comes to payment practices and called for the introduction of a statutory requirement for suppliers to be paid within thirty days. They further suggested that retentions should be replaced with independently managed project accounts. It is worth noting that project bank accounts are now mandated by the Scottish government for most public sector projects from March 2019. Retention should be kept in an independent account, but this is rarely done.

Once a project is underway it is important to remain vigilant and actively monitor all the potential indicators for warning signs.

Organisations might help to ease cashflow pressures on large-scale, long-duration projects by making judicious use of the contract provisions regarding the payment on account for materials manufactured and stored off site, where previously these provisions may have been struck out of the contract by default. In the right circumstances, advance payment provisions might also be considered for singular packages of work such as cladding, provided that the necessary bonds and guarantees are in place to help reduce the latent client exposure to risk.

Formal project controls may also help to anticipate problems at an early stage. The project's quantity surveyor will generally use the project cashflow as an indicator of progress, but on major projects an earned value management process could provide a powerful technique for measuring project performance and progress in an objective manner.

Conclusion

Nobody wants to deal with a contractor defaulting on their project, but the traditionally precarious nature of the industry, aligned with the ongoing economic headwinds and uncertainty that we are presently experiencing, makes this a real and present danger.

There are no guarantees, but it is reassuring that the leading client and contracting organisations do recognise that old practices are no longer sustainable and that a more positive and proactive approach to managing this risk, using some or all of the points included in this article, will have significant long-term benefits.

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