Construction activity and market outlook

United Kingdom - Q4 2018

As we enter the final phase before the EU withdrawal date of 29 March 2019, with all eyes firmly on Parliament, construction output is still recording growth, despite significant macroeconomic headwinds. The unprecedentedly comprehensive defeat of the government vote on the proposed withdrawal agreement leaves us with no better clarity as to the outcome of the Brexit process, and this uncertainty is dominating the economic climate. At the time of writing all that is clear is that a significant intervention is now required to prevent the UK leaving the EU without a deal, a scenario which businesses appear to view as the worst-case option.

If we were to accept that markets would react badly to a no-deal outcome, at least in the short term, and our trading relationship switched to World Trade Organisation rules, the construction industry could be exposed to several negative impacts which could substantially change our industry forecasts. In extremis, this could include: a rise in the cost of imported materials and a delay in procurement, further constraints on the available labour force, and a further delay or deferment in the making of strategic development decisions by investors and developers.

However, given that the only majority view in Parliament appears to be against a no-deal outcome, our analysis continues to take as its base that a deal to preserve at least some aspects of our current relationship will be realised, albeit over an indeterminant timescale, possibly through an extension to the Article 50 withdrawal provisions and/or an extended transition period.

In the UK, GDP grew by 0.3% in the three months to November 2018, compared with the previous three months (0.4%) and increased by 1.5% compared with the same period a year earlier. This is the weakest pace of growth in six months. The most impacted sector is manufacturing which is also exposed to wider global factors such as the slowdown in China, US trade wars, and the weakening economies in some EU countries, notably Germany, Italy and France. Jaguar Land Rover and Ford recently announced substantial workforce reductions. November also saw a widening of our trade deficit suggesting overseas companies are reducing reliance on British goods pending greater clarity over Brexit. Despite this, the ONS data showed that construction output increased by 2.1% in the three months to November 2018, and by 3.3% year-on-year, the main drivers being private new housing and repair and maintenance.

Overall, Treasury data of GDP growth from a range of forecasters has softened slightly, but remains broadly stable: 1.5% in 2019, but around 1.8%pa over the following three years.

As we enter 2019, CPI is now 2.1%, down from 3.0% at the start of 2018. This closer alignment with the Bank of England's 2.0% target threshold may hold off a further base rate rise, which was kept at 0.75% in November and underpins the view of many forecasters that CPI should stay at around 2% over the next four years.

Sterling remains comparatively weak. By year end the pound was at a near two-year low against the dollar ($1.27) and at a three-month low against the euro (€1.10), although both ratios have improved since.

Currie & Brown's UK TPI forecasts assume a 'soft' Brexit scenario. The figures are mostly in line with previous forecasts, with some minor revisions to reflect local regional factors both in 2018 and onward. In general, our forecasts anticipate a continued economic slowdown through 2019 and 2020, before moving to growth from 2021.

Materials and commodities costs:

The BCIS Materials Cost Index was up 3.3% in the year to December 2018. A slight easing on earlier figures. Forecast to remain between 3-4% going forward. [BCIS]

Labour costs:

The unemployment rate stabilised in the second half of 2018, at the historically low rate of 4.0%. Employment in construction was also stable, rising 1% in Q3 2018. Average weekly earnings in construction increased by 3.8% in the year to Q3 2018, slightly above the rate for the wider economy of 3.3%. [ONS]

Inflation:

As we enter 2019, CPI is now 2.1%, down from 3.0% at the start of 2018. [ONS] This broad return toward the Bank of England's 2.0% benchmark may hold off a further base rate rise which was kept at 0.75% in November. [Bank of England]

Insolvencies:

Construction-related compulsory liquidations in the UK spiked in early 2018 (post-Carillion), but are now just 5% up year-on-year after a 15% fall in Q3 2018. [BCIS]

GDP:

UK GDP is recording a modest growth of 0.6% in Q3 2018 and 1.5% over the year. [ONS]

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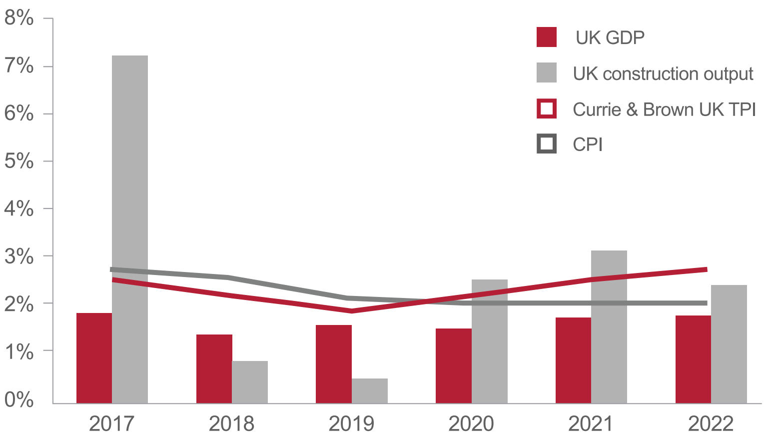
Brexit is the biggest factor affecting the construction industry now as many big investment decisions are being deferred until the manner of our exit from the EU post-March 2019 is confirmed. The strongest performing sectors are residential and infrastructure. The major Crossrail project, creating new high-speed travel through London from the west to the east, opens next year, just as the new High Speed 2 (HS2) rail lines linking London to the Midlands and the North are now gathering pace. This should open significant opportunities for new residential, commercial and mixed-use development across the country. There is some materials price volatility with imported products due to a fall in sterling. Skilled labour is at a premium, with some shortages exacerbated by a fall in the numbers of eastern European operatives. Wages rose 2.9% in the calendar year 2018. Overall, construction prices rose 2.2% in 2018 as contractors kept margins low to stay competitive. Tender price inflation is expected to ease slightly in 2019 to 1.9% due to the continued impact of Brexit before recovering to 2.1% in 2020. In response to government targets to increase housing supply, and to help deliver our 2050 carbon reduction targets, the industry is investing heavily in new smart technologies, energy efficiency measures and also in a greater use of off-site modular and volumetric construction to reduce on-site construction times and waste, and to reduce reliance on traditional on-site labour.

UK tender price inflation by region (%)

Region	2017	2018	2019	2020	2021	2022
East Anglia	2.4	1.8	1.4	1.5	1.8	2.0
East Midlands	2.5	2.1	1.8	1.8	2.0	2.3
West Midlands	2.5	2.0	1.7	1.9	2.3	2.7
North East	2.1	1.4	1.6	1.8	2.1	2.2
Yorkshire and Humber	2.4	1.9	1.8	2.1	2.4	2.5
North West	2.5	2.3	2.0	2.0	2.4	2.6
Northern Ireland	2.5	1.2	1.2	1.5	2.0	2.0
Scotland	2.0	1.7	1.6	1.9	2.1	2.2
Central London	3.1	2.9	2.4	2.7	3.4	3.6
South East	2.5	2.1	1.7	2.4	2.8	3.0
South West	2.7	2.3	2.1	2.4	2.4	3.0
Wales	2.2	1.2	1.3	1.7	1.8	2.0
UK average	**2.6**	**2.2**	**1.9**	**2.1**	**2.5**	**2.8**

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 (%)



ONS figures indicate that the total volume of construction orders in the UK rose by 3% in Q3 2018, compared with the previous quarter, but concerningly are 31% lower compared with a year earlier.

The strongest performing sectors remain residential, infrastructure and private industrial. Other sectors, in particular commercial, remain weak. The recent RICS commercial market survey showed that occupier demand fell in Q3 2018 by around 9%. Our forecast would be for construction output to remain flat, at least during 2019. Beyond this, we may benefit from infrastructure output being set to hit a high in 2020, driven by activity on major national projects such as HS2 and Hinkley Point C.

Geographically, the picture is mixed. London inevitably dominates the output figures, but its pace of growth is lower than some other areas, and the market is tightening. The Greater Manchester area is very strong, and we are also seeing higher levels of activity in the Midlands and the South West. Other parts of Northern England, the South East, Wales, Scotland and Northern Ireland are much quieter.

As previously reported, the procurement picture is somewhat divergent between smaller-scale and larger-scale contracts. The former shows a greater general keenness in pricing and scope for single-stage competitive tendering. Larger projects are still experiencing a higher level of inflationary pressure, which we attribute to the relatively higher degree of complexity and therefore risk profile, and more exposure to overseas procurement, so two-stage or negotiated tender routes are more likely to prevail. In the past year, the highest level of cost uplift has been seen in the MEP services, around 6-8%, but evidence is growing of a hardening in pricing in the up-front trades such as piling, groundworks and demolition.

Brexit is clearly impacting the procurement market, with contractors striving to balance their desire to secure pipeline against a continued caution over the pricing of risk. Brexit is becoming a factor in the negotiation of contract terms, and the ability to secure products to meet programmes is influencing the selection of supply chain partners. Prudent teams are actively planning for the early ordering of materials or manufacturing slots to minimise the risk of delivery delay. We do believe, however, that contractors are still absorbing margin to remain competitive.

How to get best value from two-stage procurement in a challenging market

For some time, our market analysis has highlighted the prevalence of two-stage procurement in the construction market, particularly, but not exclusively, at the larger, more complex end of the project spectrum.

In these circumstances, two-stage tendering is often a client's first choice because when it works well, it can promote optimum design solutions and active risk management through close engagement with the contracting market. It is fair to say, however, that for many participants, clients and contractors, the experience can be far from satisfactory. It has not been unknown for a project to stall or a tendering contractor to be stood down before the resolution of the second stage because a mutually acceptable price cannot be achieved.

The reasons are manifold, but at its heart is the difficulty of resolving the management of risk through the supply chain, where many companies may feel financially fragile because of legacy issues or exposure to the current plethora of external economic headwinds.

Two-stage procurement is about selecting a preferred contractor to work in partnership to deliver a mutually agreeable price and programme for a project. This is usually based upon an initial submission of a team, methodology, preliminaries and overhead and profit, with the works procured on a package basis during a second stage. Theoretically, it should afford a lower risk approach for a tendering contractor, who will typically be reimbursed for their services provided during the pre-contract stages. They may also afford the benefit of some early site works before the final agreement of the contract price, generating a programme advantage. It is not surprising that many contractors promote two-stage procurement as part of a strategy of selective tendering. They believe it affords them the opportunity to add value into the design as it continues to develop, without the commercial risks often inherent in single-stage competition.

There is no doubt that where procurement risks are high, a contractor can make a substantial contribution through early involvement, whether through value engineering, buildability, phasing or programming.

However, it is also evident that outcomes can be much less satisfactory, often resulting in tenders rising significantly over budgets, and/or the pre-construction package procurement stage taking longer than initially planned.

This article explores the reasons why this might occur and examines ways in which greater value can be achieved.

Current market trends

A recent spot check on a sample of London-based residential projects obtained by Currie & Brown indicated that 60% of the projects were being procured through some form of package-based procurement; mostly two-stage competitive, but also two-stage negotiated and, in a small number of instances, construction management. Additionally, over three-quarters of the projects used a design and build contract, so specifically, the predominant procurement route was two-stage design and build. What message can we take from this? In our view, this reflects a client-side desire for a transference of risk, and ultimately the desire to appoint a contractor based on a single point of responsibility, while at the same time realising the benefits of a collaborative approach to supply chain engagement, whether through selective competitive tendering, framework procurement or OJEU. In turn, contractors are also very focused on containing risk, and two-stage tendering should enable the time and space for all project risks to be identified and either properly budgeted for or mitigated.

There are many possible reasons why these aspirations are not always realised. In a buyer's market, clients may have been able to transfer a high degree of risk down the supply chain, with little resistance. With the market less certain, however, contractors are under increasing financial pressures, and in some instances at risk of failure, so full risk transfer is harder to justify or achieve. Without careful management, this leads to the perception of inflated cost risk premiums, which could directly affect project viability. This then raises a negative perception that causes the commissioning party to question:

- The level of genuine transparency and collaboration that two-stage offers
- The ability of teams to manage design, risk and procurement concurrently
- The benefits to be drawn from early contractor involvement
- Whether value for money is being achieved

These points might be compounded if the commissioning party further believes that enforced changes to a scheme's design to address budget issues constitute an unwelcome compromise on quality. For their part, the contracting parties become equally frustrated by unplanned delays, and enforced re-work, in the package procurement period, which may generate additional staff costs which cannot be fully recovered, and ultimately impact on their forecast margin.

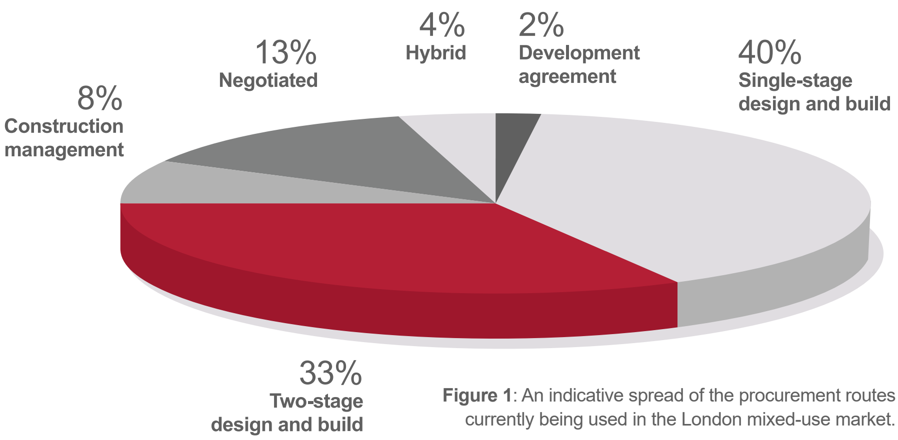


Figure 1: An indicative spread of the procurement routes currently being used in the London mixed-use market.

Structural fragmentation

Recent industry-generated reports on the future of construction have coined the term ‘structural fragmentation’, and this is a good place to start to look for solutions to improve the procurement process. Structural fragmentation attempts to define the misalignment of the supply chain’s interest and methods. For instance, the way clients approach their commercial relationships with contractors is fundamentally different from how contractors engage with their trade contractors, who in turn will have a very different relationship with their suppliers. Fragmentation of this nature must hinder any effort to improve project performance and transparency. Moreover, construction is not like defence and aerospace, which are dominated by large, lead suppliers. Construction has a more project-by-project, client-by-client approach, which acts as a barrier to building relationships or promoting innovation.

What can be done?

The route to a better outcome starts with the first-stage tender documentation, which, as a minimum, needs to definitively set out how the second-stage tender process will work and what the critical success factors are. This is normally done in a protocol that identifies roles and responsibilities, and a clear methodology for the second stage. It might also be used to set fixed rates for risk to be applied during the package procurement stage to minimise the chance of disagreement later in the process.

Clients, and their advisors, need to be realistic as to the share of risk that it is possible to transfer.

Clients should also think critically about what support they need from the preferred contractor during the pre-construction stage, and when, as this will inform the optimum point at which to engage them. Typically, this might be on completion and sign-off of the Stage 3 design, so that a clear and comprehensive set of employer’s requirements can be presented to the contractor for development. However, this is variable. A project with complex buildability or phasing issues would undoubtedly benefit from earlier contractor input. This point could also be extended to enable the client to take greater involvement in the procurement of sub-contractors. The option exists for trade contractors to be tendered directly by the client for later adoption by a successful contractor, based upon the price and terms agreed, or for package works to be included in the pricing requirements of the first-stage tender, assuming the design is sufficiently advanced to facilitate this. For the long-term asset holder this market engagement could help develop solutions promoting the through-life performance of the building. Engaging with a contractor too late may lose the key perceived benefit of two-stage tendering, which is the familiarity that contractors gain with the scheme’s design which makes them well-placed to recommend the most effective early works and constructability issues to help de-risk the project.

In respect of the employer’s requirements, consideration should be given to ensuring that they are tailored to definitively set out what the client wants the scheme to deliver, and which items are to be specifically retained for later client choice, while at the same time affording some development by the contractor to deliver the best value-for-money solution. This point applies also to the supply chain. Much benefit can be gained by engaging early with potential key specialists to test specification solutions and obtain budget prices. Clients need to start thinking about how they are dependent on and responsible for the supply chain, rather than only thinking about the procured main contractor. Without close engagement, the supply chain might otherwise only fully commit once the contractor is appointed or planning is secured. External factors, notably Brexit, where outcomes are uncertain will generate resistance to offering fully fixed prices for the whole duration of a contract. Some accommodation may also be required around cashflow/payment terms to minimise the risks which, in extremis, could lead to contractor insolvency. Clients should take the time to get to know the companies concerned so that all parties’ aspirations, constraints and concerns can be tabled and addressed before the tender process is embarked upon. Once this key decision is taken, it is essential to set up and implement a robust design and procurement programme. The quality of the design information is critical. Designers need to produce package-based information that is compliant with the employer’s requirements, co-ordinated, clear and, as far as possible, complete. As the pre-construction period develops

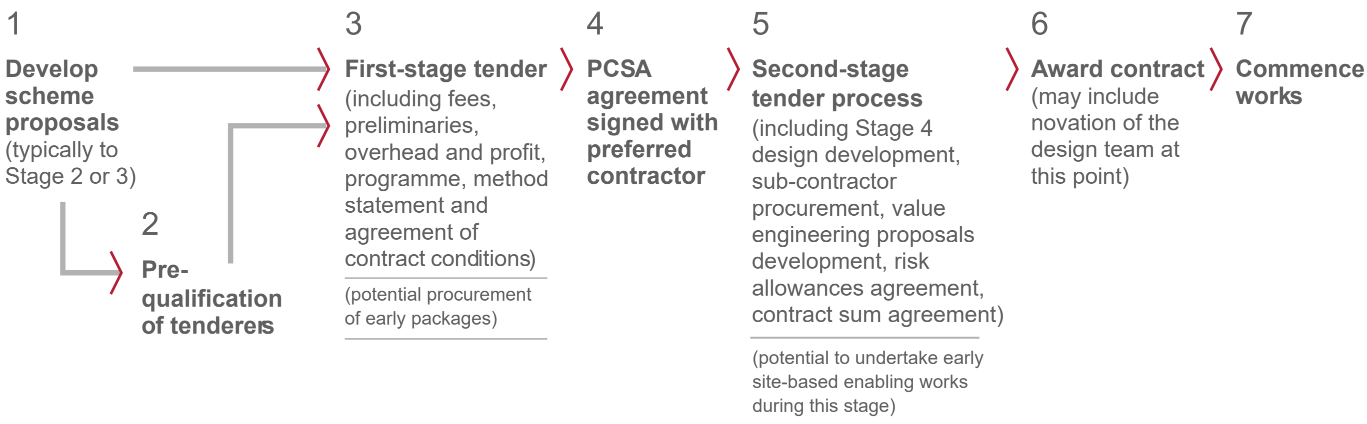


Figure 2: A typical process flow chart for two-stage procurement.

there must be an effective change management protocol in place. Change is inevitable but can be highly disruptive to the tendering process if proper accommodation is not made for this.

In the spirit of collaboration, there are benefits to be gained from managing the budgets in an open-book manner with the contractor during the pre-construction phase, and indeed, this is closely aligned with the package procurement process. As a first activity, the budget should be apportioned on a package basis consistent with the way the project will be procured. These budgets should be overlaid onto a comprehensive tender activity schedule. To drive best value where it is most important, consideration should be given to prioritising the procurement of key packages, with the agreement of sums for minor packages based on negotiation. Generally, during the second-stage tender period, the design team might be retained by the client, before being novated upon agreement of the contract. In this situation, it is important to set out who is responsible for managing the design team (usually delegated to the contractor as part of their pre-construction activities), and what their brief is, to avoid any confusion or conflict of interest. Contractors can be incentivised to improve on the client's budget during the second-stage tender via some form of shared savings arrangement.

Conclusion

There can never be a one-size-fits-all approach to tendering strategies. A successful procurement depends on the interplay between the client and the contractor based upon a clearly defined set of rules. When two-stage works well, it can build relationships which can lead to repeat work. Unfortunately, construction is often carried out in a high-risk environment where project viability or contractor margins can be easily eroded. When two-stage starts to fail, it can be that the only thing stopping the parties from walking away is that the amount of money invested into the process forces a desire to work through to make the project work. If two-stage procurement is to succeed it needs to be conducted within a clear and well-structured framework and programme, which all participants in the process understand and sign up to. A simple initiative, such as regular coffee meetings between project principals, can help set the tone for how business will be conducted, and also help to establish and maintain a collaborative approach to resolve problems for a mutually successful outcome. In the final analysis, two-stage is only a process. People are key, and the parties need to feel that they have control over the process. This can easily be achieved with some flexibility and adaptability. The potential benefits from two-stage tendering are significant:

- The ability to garner the widest possible interest from the industry to the proposed project based upon engagement in a lower risk environment
- The opportunity to build relationships, add value to the design and construction methodology and, reduce the risk profile of the project when the contractors work alongside the design team
- The opportunity for early site works
- Closer engagement between the client and the supply chain
- The positive results of collaboration

If this can be done by following some of the recommendations set out above, there is no reason why two-stage tendering should not deliver mutually successful contracts for all concerned.

Figure 3: The Makers, Hackney. One of two projects successfully procured for the London Borough of Hackney via a single OJEU-compliant two-stage tender process.

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