Turner & Townsend

UK market intelligence

Building successfully in Brexit Britain

Autumn / Winter 2020

making the **difference**

Introduction

Post-pandemic, post-EU; building successfully in Brexit Britain

Just a few months ago, Britain's decision to leave the EU was correctly being seen – and argued over – as a 'once-in-a-generation' economic event.

But the sheer scale of the COVID-19's impact has since relegated Brexit to the sidelines.

While the construction industry is rightly focusing on adapting to the pandemic, Brexit has not gone away. In fact the UK is fast approaching the end of its transition period with the EU, and from 1st January 2021 there will be major changes to the way British businesses import materials, hire people or procure from the EU.

Distraction must not be allowed to turn into disruption. We examine whether the industry is sleepwalking into its post-Brexit future, and what clients can do to make the shift successfully.

At a glance

41.9%

Quarter-on-quarter growth of UK construction industry output in Q3 2020

-1.0%

Expected contraction of real estate tender price inflation in 2021

-21.8%

The decline in GDP during COVID-19's recession

Economic overview

The speed at which GDP and construction output collapsed, and then reversed, in response to COVID-19 has been breathtaking.

After plummeting 19.5 and 40.2 percent respectively in the first month after lockdown was declared, activity picked up sharply after restrictions were eased. In the third quarter of 2020, construction output rose by a record-breaking 41.9 percent compared to the previous three months.

Positives may also be seen in construction insolvency data. Government stimulus has supported three consecutive quarters of falling insolvency figures, culminating with a decrease of 27.6 percent in Q3 2020.

In November 2020, the respected PMI survey of construction firms found that business confidence had climbed back to highs not seen since before the pandemic, with fully 51.0 percent of respondents anticipating an increase in business activity over the next year.

Our latest survey of contractors also found that the extreme hit to confidence seen earlier in 2020 was starting to reverse. A majority, 51.7 percent, of the contractors we spoke to in Q3 reported that the market would stay the same, with just 37.9 percent saying the market is getting cooler.

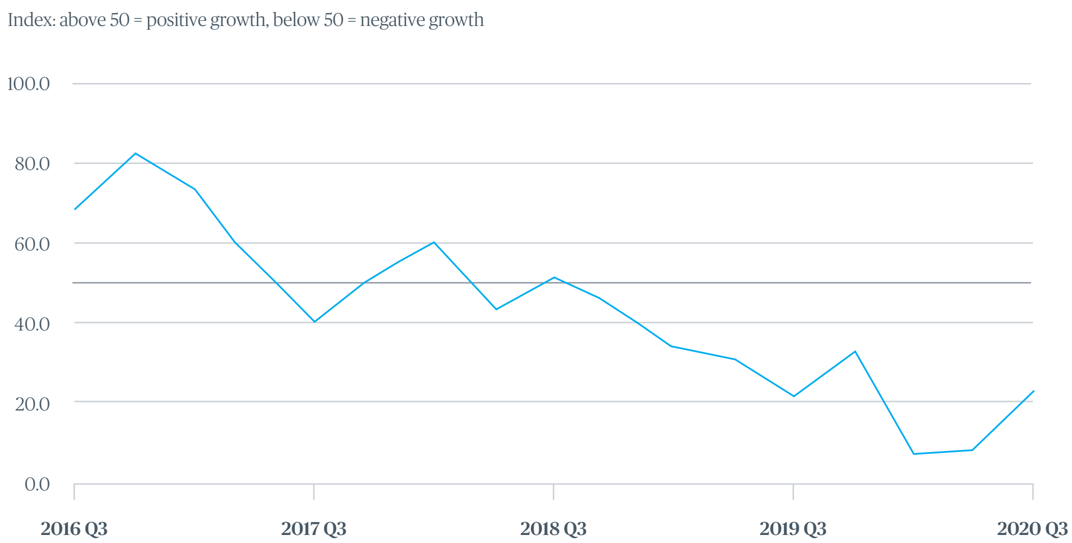


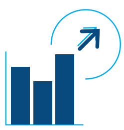
Figure 1:
Construction contractor sentiment

Turner & Townsend contractor survey: Q3 2020

Is the construction market getting warmer, cooler, or staying the same?

Economic data

**GDP growth rate calculated from levels data in the ABMI time series.*



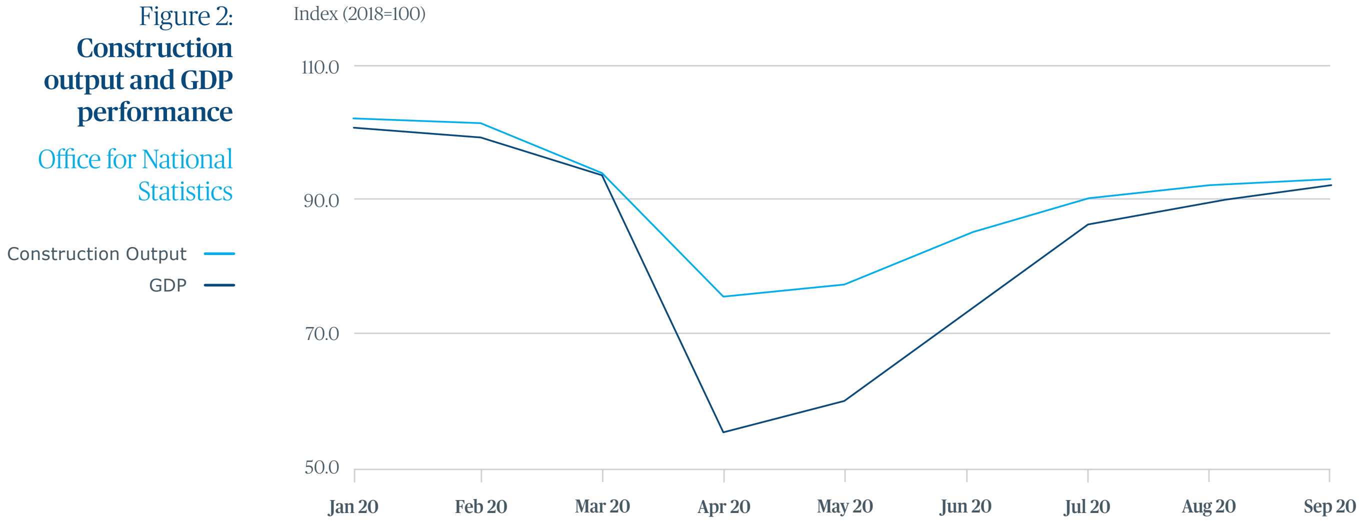
GDP at (market prices) index
Q3 2020: 91.7
Q2 2020: 79.4
Increase: 15.5%

Bank of England base rate
Sep 2020: 0.10
Jun 2020: 0.10
No change

Despite the great strides made, the recovery is far from a return to business as usual. Office of National Statistics (ONS) data shows that GDP and construction output in September 2020 were, respectively, 8.2 and 7.3 percent below the pre-pandemic levels recorded earlier in the year in February.

Figure 2:
Construction output and GDP performance

Office for National Statistics



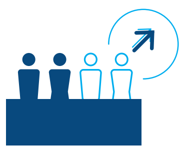
Source: ONS

With the rate of economic growth slowing at the end of 2020 Q3, and England's November lockdown pegging back progress even further, recovery is by no means entrenched or guaranteed.

Against this fragile backdrop, the industry is racing towards another momentous event with the potential to disrupt supply chains, inflate costs and even test legal contracts – Brexit.

Consumer price inflation

Sep 2020: 109.1
Sep 2019: 108.5
Increase: 0.6%



Unemployment level (thousand)

Q3 2020: 1,624
Q2 2020: 1,381
Increase: 17.6%

Construction output index

Q3 2020: 89.4
Q2 2020: 63.0
Increase: 41.9%

Key sentiment indicators

Quarterly movement

Materials	→
Labour	→
Overheads	→
Profits	↘
Preliminaries	→

Construction by numbers

Quarterly percentage change

Construction employment	-2.2%
Construction vacancies	175.0%
Construction new orders	89.2%
Construction insolvencies	-27.6%
Construction average weekly earnings	8.3%

Hot rates (price index)

Quarterly percentage change

Ready mixed concrete	-1.4%
Fuel (diesel)	3.8%
Imported sawn wood price index	2.0%
Structural steel	4.4%
Copper	7.5%

**Data values as of Q3 2020*

Tender price inflation forecast

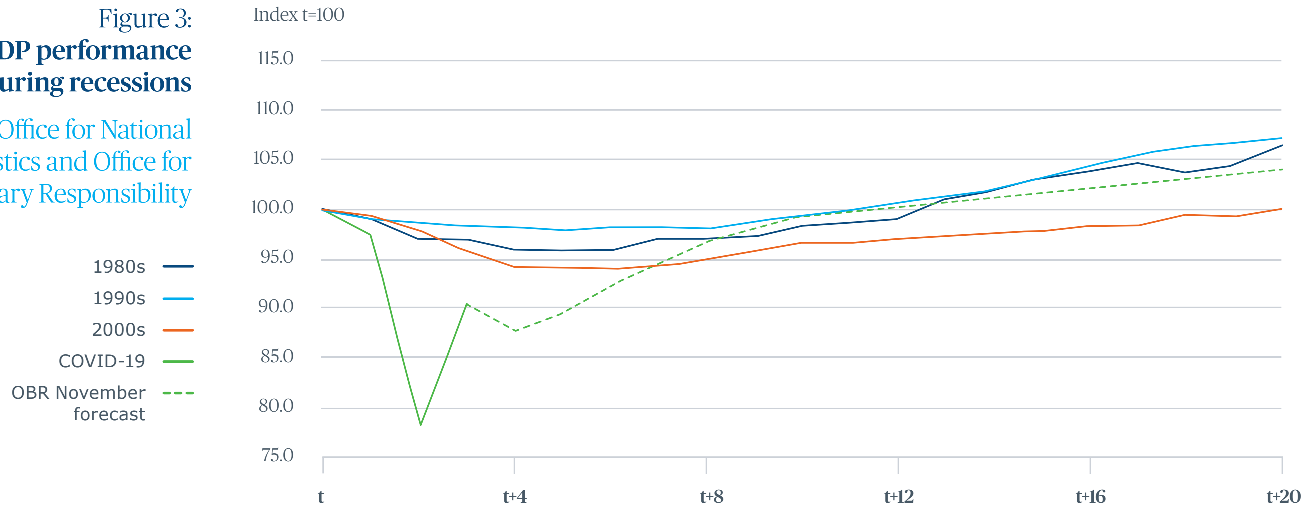
Demand continues to be the dominant driver of industry pricing

Although an initial roll-out of COVID-19 vaccinations has now begun, local restrictions remain in place and this will supress GDP and construction output growth as we move into 2021. This may place further strain on demand and add to deflationary pressures on pricing. More infections and increased restrictions limit economic activity, and this reduced activity feeds into weakened pipelines of work and deflationary pressure.

Analysis of the past three UK recessions illustrates that GDP recovery is dependent on how deeply a recession bites into the economy. The weaker the economy becomes, the longer it takes to recover.

Figure 3:
UK GDP performance during recessions

Office for National Statistics and Office for Budgetary Responsibility

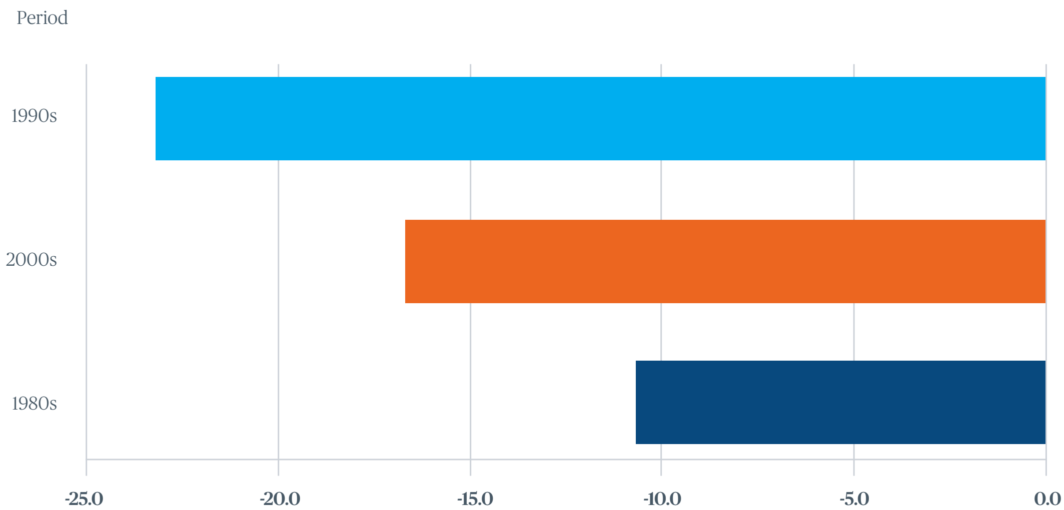


Time period: t = quarter prior to first quarter of GDP contraction, t+20 = 20 quarters, five years, after GDP contraction

Though the UK is now out of technical recession, GDP fell by -21.8 percent over two quarters. Forecasts from the Office For Budgetary Responsibility predict that GDP will fall by -11.3 percent in 2020, taking three years to return it's pre-recession peak. This mimics the timelines of past recessions. Both the 1980s and 1990s recessions took roughly three years to recover from. All recent recessions have translated into deflation, taking just over two years on average for pricing to bottom out.

Figure 4:
Tender price inflation performance as a result of recession

Building Cost Information Service: All-in Tender Price Index



Percentage change, from peak to trough, of tender price inflation as a result of recession (%)

The effect of reduced economic activity on industry pricing should not be underestimated. However, the severity of such reductions has mellowed with reports of an effective vaccine. A swift and successful vaccination programme in early 2021 could strengthen the UK's economic growth and curtail the lasting impact of COVID-19 on GDP, along with construction output and industry pricing.

In addition, the looming prospect of a 'No Deal' Brexit has the potential to keep deflation in check. New tariffs and supply chain disruption could cause material cost increases and delays, whilst impaired movement of people might contribute to increased labour costs.

The above context has been factored into our tender price inflation assumptions, with our key considerations set out below:

Scenario	Considerations
Central	■ Steady transition out of national lockdown, regional lockdowns persist until spring 2021 ■ GDP falls by -11.3 percent in 2020 and returns to pre-virus peak in 2022 ■ Residual effect of COVID-19 on economic activity ■ Peak unemployment rate of 7.5 percent ■ COVID-19 vaccine procured and administered progressively and effectively

Figure 5:
COVID-19 scenario planning

Office for Budgetary Responsibility + Turner & Townsend assumptions

Our central real estate forecast remains negative for 2021, decreasing by -1.0 percent. Competition, particularly in the private commercial sector, has increased as new orders dropped in the sector by -53.9 percent during Q2 2020.

Pressure is being placed on margins as companies look to sustain order books and ensure long term business viability and maintain liquidity. Deflation may persist as deferred tendering becomes a theme, with delays targeting lower pricing as the market bottoms out.

	Real Estate	Infrastructure
2020	-1.0%	1.0%
2021	-1.0%	1.5%
2022	1.0%	3.5%
2023	3.0%	4.5%
2024	4.0%	5.0%

Figure 6:
Tender price inflation: Annual percentage changes

Turner & Townsend

Our forecasts are representative for the UK as a whole and inflation may vary substantially by project size, value, procurement route and region. Projects need to be assessed on an individual basis and may not always align to our central scenarios. For further assistance on cost assurance and inflation analysis in your area, please contact Turner & Townsend.

Our central infrastructure forecast remains positive, increasing by 1.5 percent in 2021 as workloads are more secure. Official data shows that infrastructure output now exceeds its pre-COVID-19 level, and new orders increased by 9.5 percent on the year in 2020 Q3.

With government expenditure supporting defence, transportation and roadbuilding, this has allowed infrastructure contractors to maintain their pipelines more successfully than their real estate colleagues, despite new market entrants looking to bid low and secure work.

Figure 7:
Tender price index

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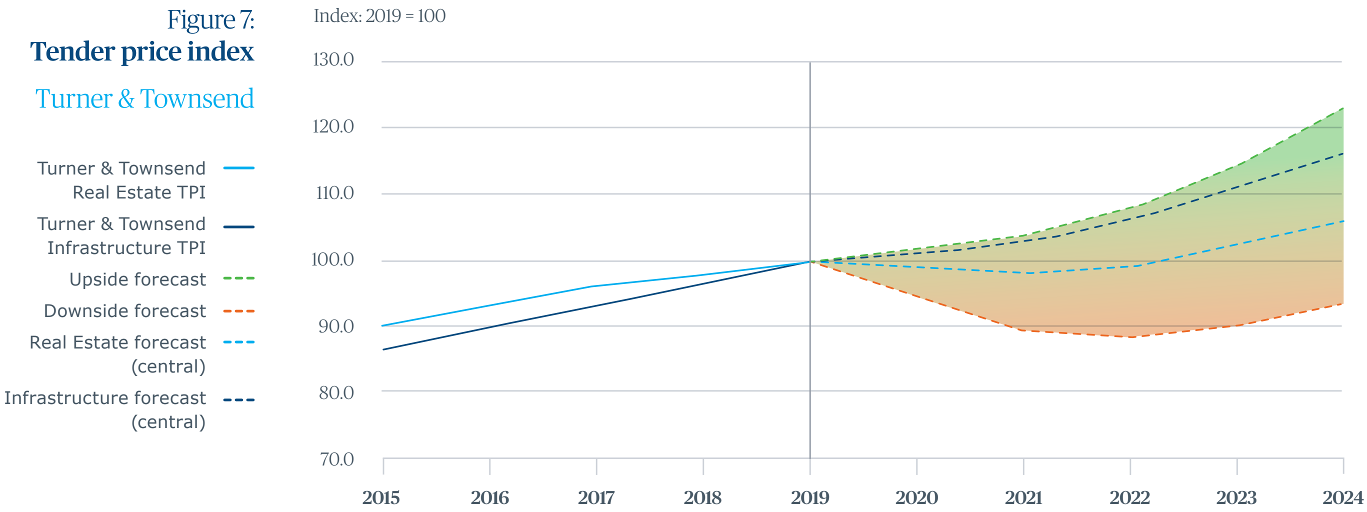


In the long term, attention must be paid to how the construction industry responds to future demand and the ongoing ripple effects of COVID-19, which are likely to cause insolvencies to rise, employment to fall and capacity to reduce.

The 2020 Spending Review unveiled the National Home Building Fund, with initial funding of £7.1bn over the next four years, a £4bn levelling up fund, and £12bn towards a Green Industrial Revolution. All of which will fuel future demand growth and cause inflationary pressure against the backdrop of a recalibrated supply chain.

Stepping out of the Brexit waiting room, on the correct foot

The UK left the European Union at the end of January 2020, and has since been in a transition period which allows it to continue trading with the EU as if it were still a member of the bloc.

However at the end of 2020 the UK will leave the Brexit 'waiting room'.

The details of the UK's future trading relationship with the EU – by far the UK's most important trading partner – have yet to be agreed.

Whatever deal is done, and whenever it comes, the ending of the transition period will thrust major changes upon the construction industry. In October 2020 the Government launched its 'Time is running out' campaign, and HMRC wrote to 200,000 firms that trade directly with the EU, to urge businesses to get ready.

For clients engaged in – or planning – a construction programme, the fallout will be immediate and long-lasting. In response, their priority must be first to ensure business continuity, and then take proactive action to mitigate each impact.

The coming months will see a multitude of risks, but they – and their corresponding risk management strategies – can be grouped into five main categories:

Material risks

The supply of construction materials is likely to be disrupted immediately. Data from the Department for Business, Energy and Industrial Strategy (BEIS) shows 59.0 percent of imported materials and components used on UK building sites in 2019 were sourced from the EU.

The ending of the transition period will see tariffs imposed on EU imports, pushing up costs. Increased friction at the UK border – with import shipments subject to customs checks and new paperwork – will also make delays more likely.

With the latest data showing that, for many key materials, lead times have barely improved since the height of lockdown, clients will need to decide exactly how these twin risks – cost and delay – are shared between themselves and their supply chain.

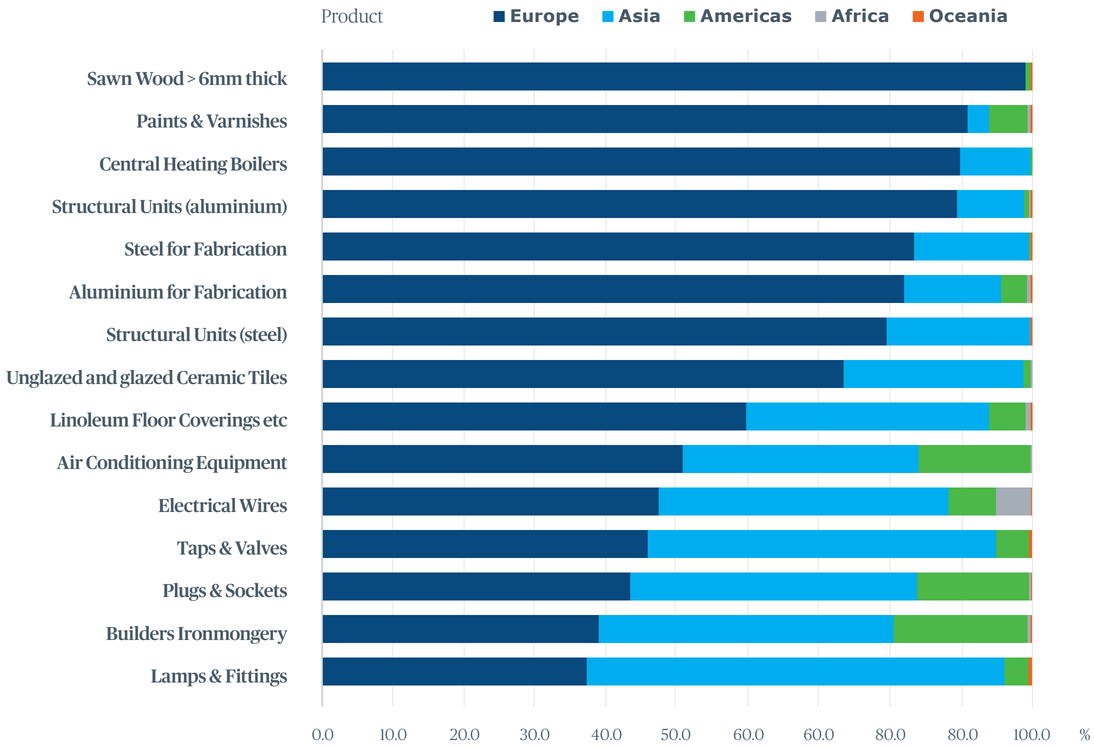
A balanced approach might be for suppliers – who are most closely connected to logistics chains – to shoulder the delay risk, with the client factoring tariffs, and corresponding controls, into its cost planning.

A good supply chain map will reveal which parts of the critical path will feel the impact most acutely. While no two programmes will be exposed to exactly the same degree, pinch points can be expected among the materials most likely to be imported.

The 15 materials and components imported most frequently account for more than half the value of UK construction sector imports. BEIS data shows a high proportion of them are procured from the Euro bloc.

Figure 8:
Proportion of UK construction materials and component imports, by region. Top 15 items by value

Department for Business, Energy and Industrial Strategy: 2019



Clients must therefore interrogate their materials supply chain in order to quantify and mitigate their exposure to material cost and delay risk. Key questions clients should ask are:

Q. Who and where are the programme's critical suppliers at all tiers?

Q. Have I created a detailed supply chain map that shows my suppliers' capacity, capability and resilience and considered any required mitigation/management strategy?

Q. Can I adjust the design to require materials and equipment (incl. temporary works) available to be sourced only from the UK or non-EU countries?

Q. Is my procurement optimised, with long-lead or overseas items packaged separately from the main procurement to allow for forward purchasing and mitigate delay?

Q. Where materials are already being imported at scale from an EU supplier, does the European company have a UK-based subsidiary through which orders can be placed instead and a tariff-free route to market maintained?

Q. Am I ready to shore up supply by stockpiling, or to enable suppliers to do so by providing advance payment or schedule adjustments?

Q. How do I maintain the attractiveness of my project or programme to the market where using a non-EU supplier is not an option?

Check the contract small print

Brexit will put contracts to the test.

The most commonly used contracts, JCT and NEC, could allow a contractor to claim additional time (under a JCT contract), or additional time and money (under an NEC contract) if the change of law entailed by Brexit can be shown to have directly affected their ability to complete the works.

Key questions clients should ask are:

Q. Do I understand the relevant provisions of my contract with respect to Brexit?

Q. Has the relevant legislation and Government advice been complied with, particularly with respect to standards and specifications?

Q. Has appropriate action been taken to comply with the conditions imposed by insurers?

Q. Is the contractor entitled to an extension of time and/or expenses? (entitlements differ under JCT and NEC contracts)

Q. Is there a commercial strategy in place to address loss and expense exposure and manage claims?

Dialling up risk management capability

Clients need to identify and have a clear understanding of the consequences of Brexit. This means having a firm grasp of all interdependencies, including: plant, materials, finished goods and labour underpinned by the knowledge of the sources and causes of risk, the likely cost and schedule implications relative to a baseline, and the potential responses supported by scenario and action planning.

Q. What risk profiles have been developed and scenario tested, which may impact the project and programme strategy?

Q. How do these risks impact the project and/or programme strategy?

Q. What mitigations have been devised and scenario tested?

Q. Have scenarios been worked up jointly with suppliers?

Labour pains

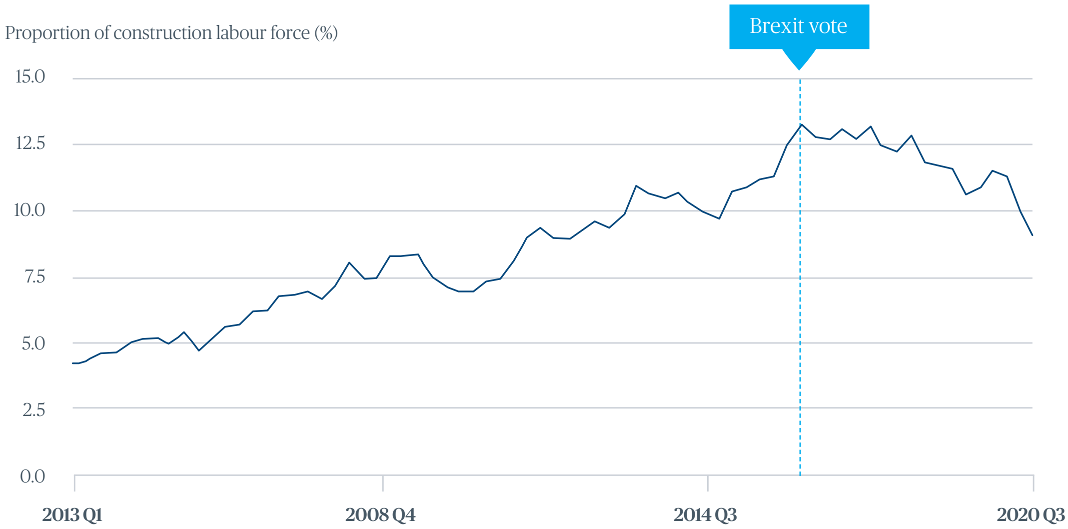
At the start of January 2021 the free movement of workers between the EU and the UK will end. EU citizens moving to the UK to work will need to secure a visa in advance, and UK employers wanting to recruit skilled European workers will need a sponsor licence to do so.

For much of the past decade, contractors have got round construction's ongoing skills shortage by importing skilled workers from abroad, with the EU providing a large and accessible pool of talent.

On the eve of the Brexit referendum in June 2016, 13.4 percent of the UK labour force was made up of migrant labour. At the end of Q3 2020, this figure had fallen to 9.1 percent.

Figure 9:
The number of migrant workers as a share of the UK construction workforce

ONS Labour Force Survey



This reduction is even sharper in London. The Construction Products Association state that since 2018 the overall number of employees in construction in London has fallen by 14.0 percent from 300,000 to 259,000.

The end of the Brexit transition period poses two serious threats to labour supply: from 2021 employers will find it harder and more time-consuming to import skills from the EU, and European candidates may be put off applying for work in the UK.

An interruption to the supply of skilled labour could translate into two significant programme risks; input cost inflation and an increased danger of overruns. While the shortage of skilled workers is a long-term, systemic problem that won't be solved until the industry as a whole makes construction sector careers more attractive to UK school-leavers, the immediate priority for clients is to ensure their continued access to sufficient labour.

Key questions clients should ask are:

Q. Does the tender process include a thorough assessment of how bidders attract, retain and train staff?

Q. Are designs optimised to reduce the construction process's reliance on human labour?

Q. Am I willing to secure local community buy-in by making a joint commitment with the contractor to use a high proportion of local staff?

Q. Can the supply chain provide critical resource and/or products as planned?

Q. Is the entire supply chain willing to embrace new technologies, from AI to automation and robotics, together with Modern Methods of Construction, to enable projects to be built to a consistently high standard with less on-site working?

Q. Have I ramped up my project controls sufficiently, for example with more regular and rigorous progress reviews, to assure work quality and maintain labour productivity?

Q. Am I clear how off-site labour is organised in order to facilitate future pipeline, particularly given extended furlough circumstances with the ongoing pandemic?

Q. Can I create a strong well-being culture on site to encourage skilled labour to work on my project or programme over those of competitors?

Q. Can I create a forward pipeline or programme of projects which gives labour and key supply chain partners confidence that their experience and contribution will be valued as part of a longer-term partnership?

Public procurement precipice

Public sector clients will face a significant change in the way they procure from 1st January 2021, when the current requirement to publish all significant tender notices on the Official Journal of the European Union (OJEU) ends.

Contracting authorities will instead be required to place tenders on a new, UK equivalent of the OJEU called Find a Tender. Find a Tender will fulfil a similar function to OJEU, enabling both UK and EU-based contractors to view and search for public procurement notices.

Those authorities which are currently also required to advertise on Contracts Finder, MOD Defence Contracts Online, Public Contracts Scotland, Sell2Wales or eTendersNI should continue to do so.

While many clients currently use third party eTender systems to post tender notices on the OJEU, the Government has advised that not all such software will be compatible with Find a Tender.

The replacement of such a fundamental part of the current tendering process will pose a major disruption risk if it is not executed smoothly.

More worrying still, client awareness of Find a Tender is low, and there is a danger that parts of the industry will sleepwalk into a cliff-edge change that impedes their ability to attract bids from qualified European contractors.

The EU is home to some highly capable tier one contractors, and public sector clients must act now to ensure that they continue to attract a full range of competitive bids, both from UK and overseas players.

Procurement teams must interrogate their eTender software providers and nurture their existing relationships with high-performing foreign contractors, and answer the following questions:

Q. Am I confident my current eTender software will be compatible with Find a Tender?

Q. Are all my overseas suppliers aware of the change and when it comes into force?

Q. Am I certain that European suppliers with a proven track record will search Find a Tender for tenders in addition to the OJEU?

Q. What upskilling will I need to do to ensure my staff are ready and able to use the new system?

Q. In an emergency will the procurement team be able to input / upload tenders manually to Find a Tender?

One way to face down both COVID-19 and Brexit: take back control

The sheer scale of the Covid-19 crisis has made it tempting for clients to ignore, or at the very least underestimate, the impact the end of the UK's Brexit transition period will have.

But the COVID-19 distraction should not be allowed to plunge the industry into Brexit disruption. Clients must use these final days and weeks before the end of 2020, a year dominated by the global pandemic, to optimise and activate their Brexit risk management strategies.

This is best achieved in three logical steps:

Analyse

Assess the programme's exposure to the three key risk areas identified above – materials, labour and public procurement. Place each into a risk management framework and confirm the business continuity plan.

Optimise

Stress test the assumptions underlying the plan and wargame the likely impact on critical dependencies. Keep the focus positive and pragmatic, viewing the changes as opportunities as well as risks. After the upheaval of 2020, 2021 offers the chance to do things differently, and better, in the new normal.

Realise

Select and commit to the best option and execute the plan with pace and rigour. Compute the impact on the baseline of any eleventh-hour trade deal between the UK and EU, and continually reassess the current position by revisiting the critical path. Whatever deal is, or isn't, done, be ready to operate in a radically new way from 1st January 2021.

About Turner & Townsend

We are an independent professional services company specialising in programme management, project management, cost and commercial management and advisory across the real estate, infrastructure and natural resources sectors.

With 111 offices in 45 countries, we draw on our extensive global and industry experience to manage risk while maximising value and performance during the construction and operation of our clients' assets.

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