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MARKET UPDATE

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Inflation, Brexit and Hackitt

With a variety of upward pressures, most cost commentators are now predicting that tender prices will increase over the next 4 years from an average of less than 1% in 2018 to 4% by 2021.

Brexit negotiations continue to introduce considerable uncertainty into tender price predictions. To help quantify this uncertainty BCIS has produced three scenarios going forward labelled Upside, Downside and Central to reflect their predicted impact on construction demand. We have summarised the assumptions for each overleaf. BCIS is now predicting a considerable difference between the impacts of each scenario on TPI going forward.

The Interim Report from the Hackitt Review has now been published and it is clear that significant changes to the regulatory system (and potentially procurement) can be expected. We discuss some of these overleaf.

A glance at the economy this quarter

- **UK construction witnessed a decline in Q4 2017.**
- **Construction output fell 2% in Q4 2017.**
- **Private housing output decreased 4.1% in November 2017 compared to October 2017.**
- **By value, the residential sector has had the highest proportion of contracts awarded in 2017, accounting for 35%**
- **London has received the highest proportion of contracts awarded by region in 2017, accounting for 20% of UK total, totalling around £14 billion**

Tender Price inflation forecasts

Figure 1 Tender price inflation forecast (Source: Various)

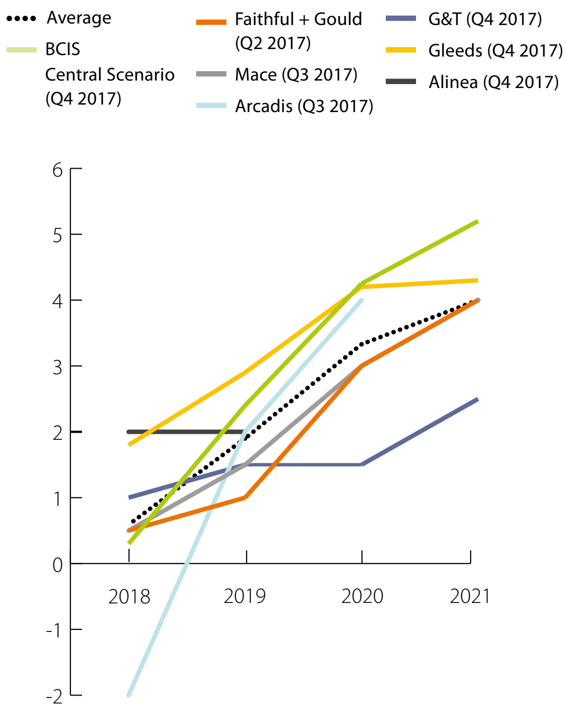


Figure 1 presents revised tender price inflation between 2018 and 2021 envisaged by some major consultant's post-Brexit along with BCIS.

There continues to be significant uncertainty going forward. The upward pressure from material price increases and wage inflation is being offset by continued uncertainty over the Brexit aftermath and likely slowdown in house sales from an anticipated rise in interest rates. Most analysts are predicting that tender price inflation in 2018 will be well below the current RPI inflation rate of 2.7%. The mean of these predictions is 0.7%.

The downward corrections previously predicted for 2018 have now been replaced by uniformly upwards projections. Although a number of commentators have adjusted their predictions since our last Market Update; the averages for 2019 and 2020 have stayed largely the same at 2.1% and 3.3% respectively. Cost commentators have now also added predictions for 2021 which show a continued escalation in the TPI to an average of 4.0%

0.4%
GDP (Q4 2017)

2.7%
Inflation (RPI) (January 2018)

-4.3%
Construction unemployment (Q1 2017)

5.3%
Construction material price index (Q3 2017)

3.9%
Housing construction material price index (Q3 2017)

3.4%
Mechanical cost index (Q3 2017)

1.1%
Steel-framed construction price index (January 2018)

2.5%
Electrical cost index (Q3 2017)

0.8%
Concrete-framed construction price index (Q4 2017)

Base = 0
In comparison to previous quarter

A look at Hackitt

As the industry welcomes the Hackitt Review of Building Regulations and Fire Safety, there are likely to be some significant changes across the industry in dealing with fire safety. Although it is unclear what the quantification of the impacts of these changes will be, we look at some possible implications:

- There are already signs of supply chain 'bottlenecks' in compliant cladding solutions for retrofit as well as new-build. The estimate for recladding a residential block in London has reportedly doubled in the last three months.
- Insurers are starting to significantly increase premiums on existing high-rise buildings with flammable cladding panels and no sprinklers which will subsequently increase the urgency and demand of compliant cladding for retrofit.
- Product prices may also increase due to the additional testing and certifications that will be required.
- Maintenance costs are likely to increase as additional periodic review/assessments and recording of any changes or refurbishments will be required.
- The increased focus on quality control is likely to add oversight costs as thorough checks will be required which will add time delays to construction.
- The need for a Responsible Person is likely to add preliminary costs to schemes.
- Additional testing may be required as the Government may restrict or remove the use of desktop studies to approve any changes to cladding systems.
- Labour shortages are likely to add further time and cost implications.
- Demand and subsequently prices for scaffolding for façades is also likely to increase significantly.
- Additional skills and accreditations are likely to increase overhead costs for companies.

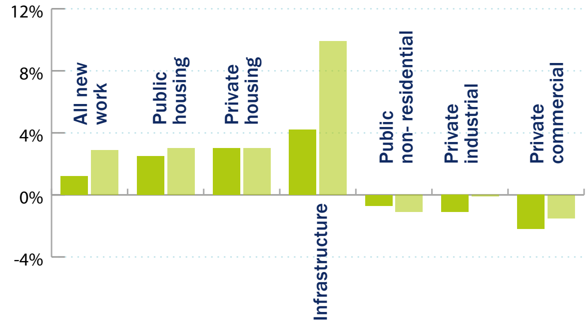
Average wages vs House prices

Figure 2 Average wages vs house prices (Source: *Land Registry, **Monster UK and ***Home.co.uk)

	UK	London
Average house price*	£226,071	£481,000
Average earnings**	£26,275 (£2,190/month)	£35,053 (£2,921/month)
Average mortgage repayment	£1,183/ month	£2,518/ month
Average rent***	£907/ month	£1,524/ month
% spent on mortgage	54%	86%
% spent on rent	41%	52%

Construction output forecast 2018 -2019

Figure 3 Average construction output forecast by sector (Source: CPA, Experian)



Three Brexit scenarios

In order to help quantify the potential impact of Brexit, BCIS has now started to produce 3 separate TPI predictions based on three Brexit scenarios.

These scenarios are described below and are labelled to reflect their different predicted impact on construction demand.

- **Upside** scenario - UK remains a member of EU with no voting rights from cessation of the 2-year period following signing of Article 50. 2-year transitional period follows with 'smooth' negotiations with trade agreements being the same as prior to EU referendum. Sterling exchange rates remain depressed until end of transitional period and return to pre-EU referendum levels. Reduction in imported materials, free movement of EU labour and the economy picking up during transitional period.
- **Downside** scenario - UK has a 'hard Brexit'. Any trade agreements with EU are a lot less favourable and there are restrictions on movement of labour. Sterling exchange rates worsen which affects price of imported materials and desire for EU labour to work in the UK. UK Starts paying 'divorce bill' from Q1 2019 and economy goes into recession during transitional period only recovering at the end of forecast period.
- **Central** scenario - UK remains member of EU with no voting rights following signing of Article 50. 2-year transition period with continued payments to the EU and any trade deals are less favourable. Sterling rates remain depressed until end of transitional period and then gradually return to pre-EU referendum levels. Free movement of labour continues until the end of transitional period with restrictions after that.

The downside scenario shows significant reduction in TPI in 2019 whereas the upside scenario shows no levelling off in 2019 but shows a continuos upwards trend up to 2022.

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