MARKET UPDATE

Back on track as growth returns

February 2022

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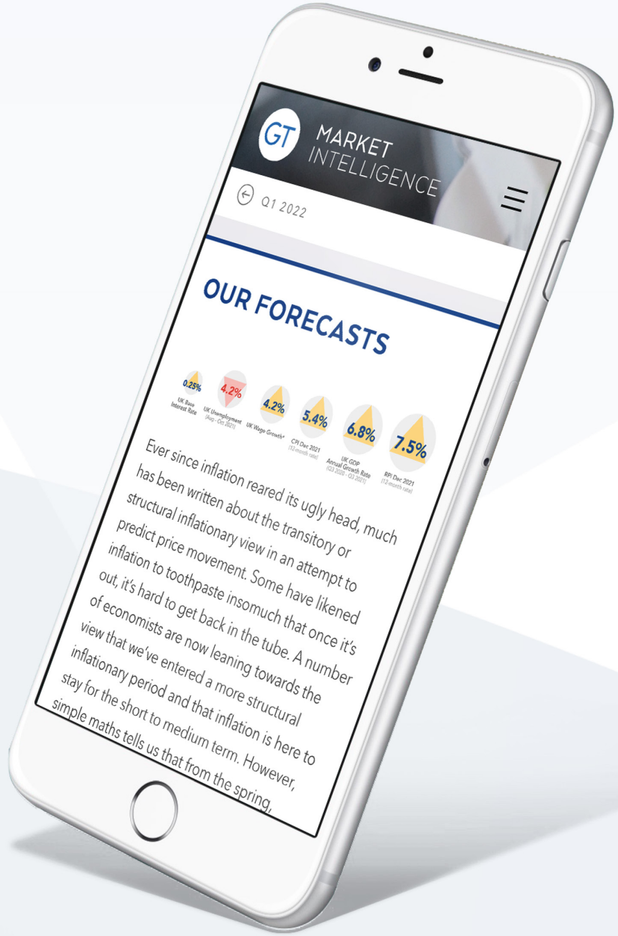
G&T's Market Update for February 2022 provides an overview of the UK construction market. Against a backdrop of improving supply chain conditions and increased construction input cost pressures, our latest report highlights changes to key macro-economic indicators over the reporting period, as well as construction-specific metrics such as the IHS Markit/CIPS UK Purchasing Managers' Index (PMI), construction output, new orders and key material costs. Also outlined are our latest trade package and tender price inflation forecasts based on our quarterly surveys and regular discussions with the supply chain.

In this update we:

- Analyse various datasets to provide a macro-overview of the UK construction sector against the current inflationary landscape
- Review the factors that are putting upward pressure on input costs as demand strengthens and workloads rise
- Consider how contractor workloads and the current market conditions are impacting tendering
- Explore recent shipping, transport and energy cost movements and the underlying reasons for any changes

Please note – whilst our Market Update uses the most recently published data at the time of writing, release schedules between datasets differ. This inevitably means that not all datasets will cover identical periods.

Click **HERE** to view the TPI online



UK economy
EXPANDED
BY
1%
(Q4 2021)

Bank of England
expects inflation
to peak at
7.25%
in latest forecasts

UK economy
returned to pre-pandemic levels in November

Material
Price Index
(All Work)
21.5%
(Dec 2020 - Dec 2021)

Sustained price pressure on **energy-intensive** construction materials

Signs that commodity prices are nearing an **inflection point**

UK
Construction
PMI
(Dec 2021)
54.3
(Jan 2022)
56.3

UK
Construction
NEW ORDERS
(Q4 2021)
9%

UK
Construction
OUTPUT
(Q4 2021)
0.9%

Consumer Spending Growth Slowed

UK consumer spending rose **7.4%** in January (Y-on-Y)

OECD: UK to Outpace G7 Rivals

OECD expects UK output growth to be **4.7%** in 2022 and **2.1%** in 2023

Strong Building Materials Market

Builder merchants' sales grew nearly **30%** in 2021 during the supply chain squeeze

Commodity Prices Climb Higher

Commodity prices continue to **surge after a brief lull**, suggesting more inflation is on the way

UK Construction PMI 56.3 *(Jan 2022)*

After a more subdued period towards the end of 2021, UK construction gained momentum in January as commercial activity surged

CPI 5.4% *(Dec 2021)*

Annual inflation rose to its **highest level in almost 30 years** with rising energy prices being a key inflationary pressure

0.5% Base Interest Rate

Base rate rose for the second time in three months in bid to cool soaring prices

Brexit reduces trade with EU

UK-EU trade in first year post Brexit **failed to rebound**

0.9% UK GDP *(Nov 2021)*

UK economy estimated to have grown **0.9%** in November, taking it back **above its pre-pandemic level**

4.1% Unemployment Rate *(Sep – Nov 2021)*

Unemployment rate on a downward trend, as job vacancies increased

4.6% UK Construction Earnings

Average weekly earnings in construction (Y-on-Y three-month average) rose **4.6%** in Nov 2021

Source: *Reuters, OECD, Builders Merchants Federation, S&P Global, IHS Markit, ONS*

The UK Economy

The UK economy grew **7.5%** in 2021 – the fastest pace of growth for 80 years. The strong start to 2021 slowed in the second half of the year with shortages of labour and materials, as well as weaker export volumes after Brexit. However the construction project pipeline remained strong.

GDP growth showed a stronger than expected 1% in the last three months of 2021.

According to the Bank of England's Monetary Policy Report – February 2022:

- After depressed activity in December and January, GDP is expected to recover in February and March back to pre-pandemic levels once again by the end of Q1 2022.
- The rate of inflation was above target at **5.4%** in 2021. Rises in oil/gas prices and imported goods alongside the shortages of materials and labour pushed up costs and consumer prices.
- Inflation is expected to rise further to around **7%** in the spring but expected to fall as the impact of higher fuel prices fade, demand for goods moderates and production difficulties ease. The BoE expects inflation will be close to its **2%** target in around two years' time.
- The UK unemployment rate is expected to tighten and fall to **3.8%** in Q1 2022 but then rise to **5%** by 2025. This primarily reflects demand growing by less than the economy's supply potential, driven in turn by the increase in global energy and tradable goods prices squeezing real incomes.

Source: *ONS, Bank of England, ONS – International Trade*

UK Construction

The UK construction sector grew at its fastest pace in six months in January as cost pressures further diminished and concerns over the Omicron variant reduced.

Business activity is signaling the strongest rate of output expansion since July 2021. Construction companies' positive business outlook reflects increasing tender opportunities and expectations of a swift recovery for the UK economy in 2022.

2022 has started well with new orders expanding rapidly since last August. Although higher energy, transport and raw material costs led to increases in input pricing in January - fewer supply issues helped ease the overall rate of input cost inflation to its lowest since March 2021.

The construction industry was hit with shortages and rising material prices in 2021, causing delays on some projects and making tendering to budget challenging. Towards the end of the year price rises softened and supply issues eased, although demand for materials and products remains strong. Helped by the seasonal reduction in construction activity we start 2022 with positive stocks and availability of most products.

Rising gas prices have affected energy-intensive heavy construction products such as bricks, cement and metals, where energy accounts for approximately one-third of the manufacturing cost.

Material Prices and Energy Price Rises

Material shortages are easing but increasing energy costs are set to become a key driver of building cost inflation in 2022.

The BEIS ‘All Work’ material price index rose by **21.5%** in the year to December 2021. However, the rate of inflation eased towards the end of the year and in November, the index was flat for the first time since September 2020.

Both fabricated structural steel and imported timber prices fell in the three months to December (by **-3.6%** and **9.1%** respectively). However sustained high energy costs and strong demand will add cost pressure in 2022. Higher manufacturing costs may be partly absorbed by producers but may be passed on to contractors via surcharges.

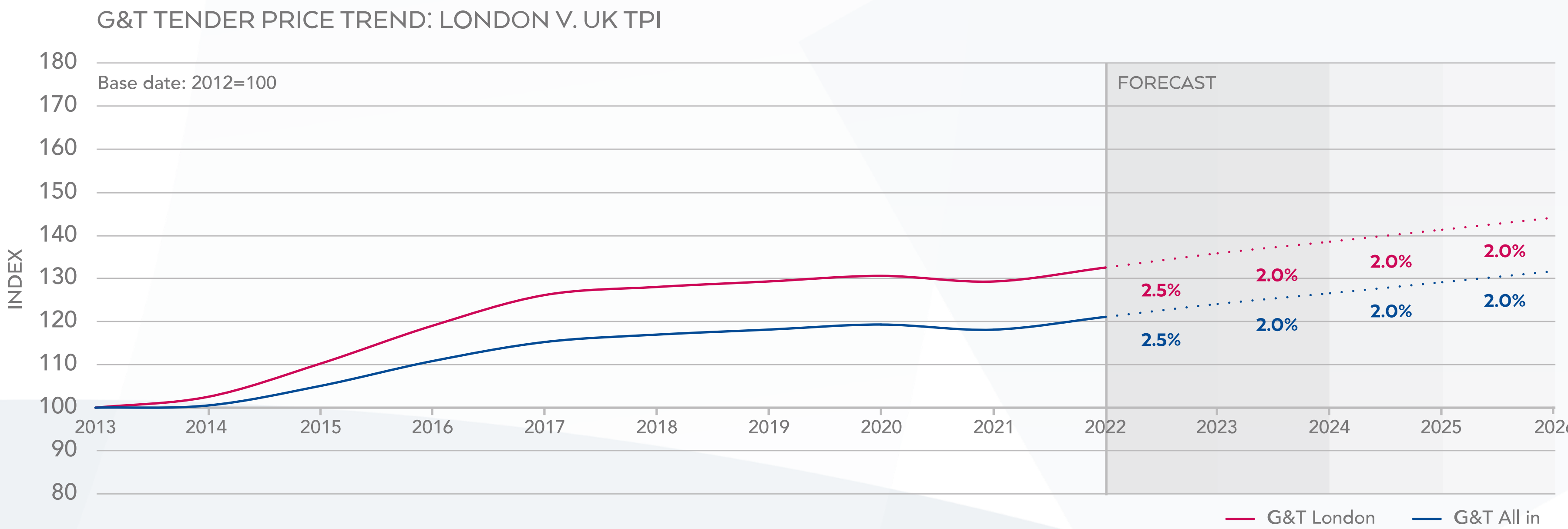
Contractors' costs may rise due to higher electricity prices increasing the cost of running construction plant - particularly after the “red diesel” duty exemption is removed in April.

Shipping and Logistics
Full customs checks came into effect on 1st January 2022, ending the grace period on EU imports to the UK. This will increase immediate costs and cause congestion at ports. Higher fuel prices will also put pressure on logistics costs in 2022.

The Baltic Dry Index (BDI) – an index of average prices paid for the transport of dry bulk materials (eg coal and steel) across more than 20 routes – has fallen more than 75% from its peak on 7th October 2021. The BDI is now more in line with the five-year average, indicating that the global supply chain crisis is abating and that goods are moving again.

At G&T we’re able to respond to inflationary pressures quickly by ensuring market conditions are tracked to allow for the most accurate pricing as well as utilising our extensive benchmarking technology when advising our clients.

Source: *Department for Business, Energy & Industrial Strategy*



- Sector-dependent two-speed recovery is emerging in terms of construction activity growth, but the UK construction sector is set to remain in a continued inflationary environment to 2025
- Transitory v. structural inflationary debate ongoing but economists are leaning towards the view that we've entered a more structural inflationary period
- Strong inflationary rises likely to be experienced this year but from spring some price rises will drop out of the inflation data, leaving us with higher price levels but a lower headline inflation rate of change
- Confluence of various input cost pressures to weigh in on tender pricing and construction costs, but likely to be labour-led
- Material and labour inflation to be tempered by the need for main contractors to fill their 2023/24 pipeline
- Inflationary rises across all regions are anticipated, but likely to see a front-loading of inflation in the first half of 2022
- Following this demand-side factors contributing to higher material price inflation will fade and supply-side inflation factors will begin to normalise
- Last year's surge in energy prices is widely expected to unwind as the year progresses but wholesale energy prices will likely remain well above historic levels throughout 2022
- Supply chain pressures are improving and UK plc returning to normal working patterns

TPI SURVEY FEEDBACK: WORKLOAD

Workflows steady

Tendering opportunities being released regularly

General feeling of positivity in the market

Covid hesitancy subsiding

Increase in enquiries/ feasibility studies

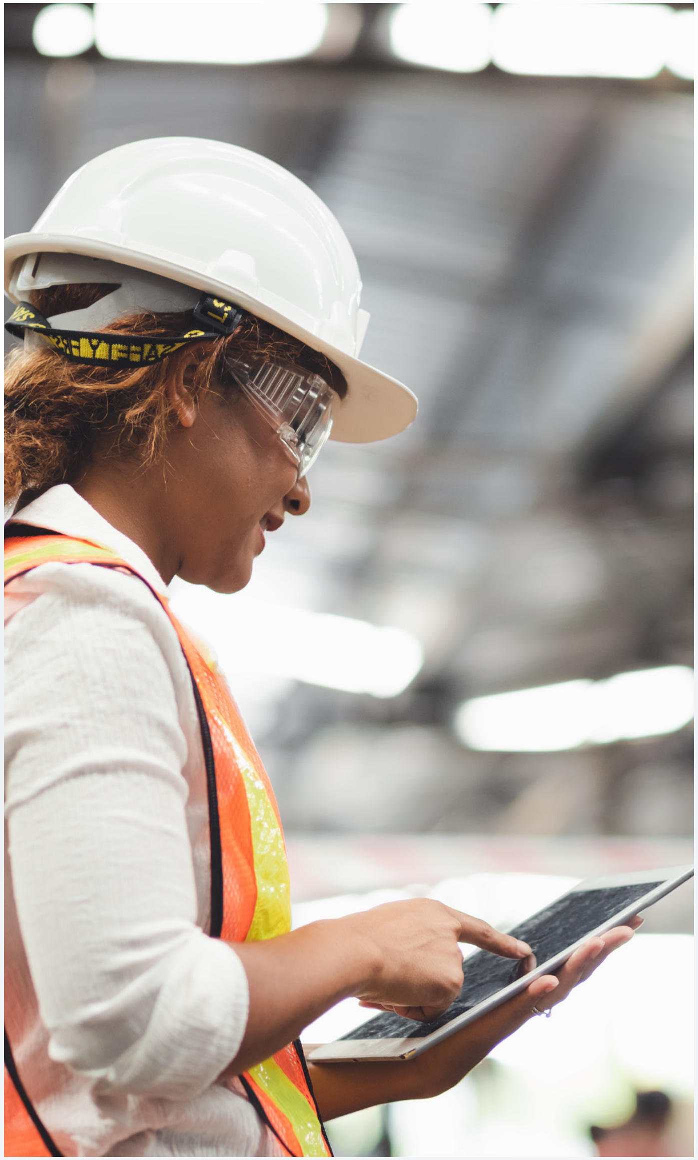
Pipeline of potential projects is strong but contractors are still keen to fill 2023/24 pipeline

Projects moving from feasibility to planning/ procurement

Capital constraints lifting as longer-term strategies being developed

Previously stalled schemes now providing steady stream of work

Unprecedented levels of growth in some sectors (eg industrial)



Key themes from our Q1 2022 TPI survey

- Tender price inflation initially lagged input cost rises, but costs are now being passed along the supply chain
- CLC is reporting significant improvements in availability of products and materials
- Early signs that supply chain disruption and delays are becoming less common/acute
- Seasonal decline in construction activity allowed suppliers to catch up on backlogged work and boost capacity
- Labour cost inflation expected to outpace material price growth in 2022
- Recent price volatility has made contractors resistant to hold prices or fix packages without adding significant premiums or backing these off with the trades
- Despite prevailing inflationary headwinds, many will see the softening of material supply issues as a reason to push ahead
- Overheating in some sub-sectors. Full order books and an abundance of opportunities is making it difficult to elicit tender returns
- More opportunities and a fear of loss-making jobs means some contractors are not chasing work as hard as they were
- Contractors and their supply chain will no longer accept blind risk or fail to price in the risk of a cost spike

CPA: construction materials most affected by rising energy prices:

- **Ceramics**
- **Bricks/blocks**
- **Steel**
- **Concrete/cement**
- **Glass**
- **Aluminium**

Products where heating is an essential part of the production process will be most affected by higher energy prices. These energy-intensive industries will pass on some of the impact of higher prices.

All sectors will be affected by the wide-ranging, energy-driven material cost increases but three, four or even fivefold increases in energy costs do not necessarily translate immediately into material prices.

Manufacturers hedge against volatility by negotiating fixed prices with energy producers, providing them with some short-term certainty. However, this effectively pushes the problem further down the line as producers factor in higher energy-driven prices into later negotiations.

For heavy-side manufacturing, up to **one-third** of the manufacturing cost can be energy costs according to Noble Francis, economics director at the CPA. Manufacturers won't be able to absorb all the additional cost but how much they pass on will to some extent depend on what contractors are willing to accept. SME construction firms, without access to scale, will likely be hardest hit by rising energy prices. In relation to cost absorption, John Newcomb chief executive of the Builders Merchants Federation (**BMF**), said:

"When manufacturers are forced to raise prices, the majority of merchants will have to pass these on to their customers, although there may be instances where part of the increase on price sensitive products may be absorbed for a time."

Mitigating steps to consider….

1. Examine contracts containing express clauses dealing with fluctuations and indexation clauses to determine if they cover situations associated with the current energy price increases. If these mechanisms exist, ensure they are being properly administered
2. Ensure early and honest communication with the supply chain to manage costs on contracts and reduce the risk of contracts being terminated
3. Use contractors that have long-term supply arrangements in place which allow them to fix prices and hedge against material price increases.

Source: *Construction Leadership Council (CLC), Construction Products Association (CPA)*

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