GT GARDINER &THEOBALD

2ND QUARTER 2020

Our Tender Price Inflation report looks at the movement of prices in tenders for building contracts in the UK. The report examines a number of contributing factors and is further informed by our market survey responses and contractor consultations.

TPI

TENDER PRICE INDICATOR

In this issue

HOW DOES CONSTRUCTION EMERGE FROM THE PANDEMIC?

INTRODUCTION

Hopes of entering into a period of relative calm and greater market certainty have firmly been put on ice as we find ourselves facing the prospect of a 'new normal' in the wake of the coronavirus (COVID-19) pandemic.

Record downgrades to economic growth have left many longing for a time when Brexit was the major risk to contend with. Coronavirus was barely a blip on the radar a few months ago and now, according to former chancellor Philip Hammond, it poses a risk greater to the economy and supply chains than a no-deal Brexit.

The wide range of forecasts estimating the damage the pandemic could do to the UK economy demonstrates just how uncertain the immediate outlook is. The scale ranges from a contraction of 3.6% to GDP in 2020 (J.P. Morgan) all the way down to the most pessimistic forecast by the Office for Budget Responsibility (**OBR**) – a contraction of 12%. Fortunately, a number of macroeconomic forecasts point to a steep but relatively short-lived contraction that will mostly affect activity in the first half of the year with a partial recovery expected in the second half.

Either way, scenario analysis is often the best technique to use in such an uncertain environment. Businesses need to plan for a range of possible shocks and so this is the approach we have taken with our latest tender price forecasts.

INFLATIONARY AND DEFLATIONARY PRESSURES

Based on our observations of the market and our extensive discussions with the supply chain we have established that there are a number of inflationary and deflationary pressures that are likely to impact input costs and tender pricing. Currently one of the most significant inflationary pressures is the reduced levels of productivity on-site due to the latest site operating procedures (**SOP**) and social distancing guidelines. However, as noted in our table below, there are a number of deflationary pressures counteracting this – not the least of which is lower demand and confidence.

INFLATIONARY PRESSURES

+ Reduced on-site productivity due to SOP/social distancing guidelines
+ Labour sourcing constraints
+ Constrained material imports (alternative sourcing at potentially higher cost)
+ Insolvencies lowering industry capacity and reducing tendering competition
+ Increased workload post recovery whilst trying to clear backlogs
+ Additional preliminaries as a result of new Site Operating Procedures (eg larger canteens and drying rooms)

DEFLATIONARY PRESSURES

- Raw commodity prices (eg oil, metals)
- Fewer new orders and tendering opportunities impacting short-term project pipeline
- Reduced on-site labour under social distancing, pushing wages and labour costs down
- Downward pressure on contractor margins in a more competitive tendering environment
- Lower demand for products and materials whilst sites are closed

SCENARIOS

Below we have outlined three potential scenarios: Good, Neutral and Poor. Each scenario includes a number of events and conditions which, if they materialise, will have varying impacts on tendering conditions.

By way of comparison we have included a brief summary of the market and tendering conditions we noted in our last TPI report (Q4 2019 TPI) and fed in to our forecasts:

	Q4 2019 TPI	Good	Neutral	Poor
CV 19 Infection levels	**None**	**New infections curve flattens**	**Flattens with limited outbreaks**	**Infection levels continue to rise**
Demand	Steady market demand	Pent up demand released	Growth market returns	Limited demand
	Uncertainty dialled back after Conservative majority win	New orders rise towards the end of the year	Investor appetite dented but some confidence returns	Investor demand is stifled due to CV19 uncertainty
	Hopes that pent-up demand would be released and confidence would surge post-election result	Return to opportunist investment demand released	Pent up demand from CV19 released	Work on site may be restricted to only 'critical' or 'essential' projects across the entire UK for an extended period
	UK businesses operating with no restrictions, normal economic activity	UK business reopen with limited restrictions, cash flow improves	UK business slowly released to allow trading and cash flow	UK business restricted, limited cash flow constraining demand
Supply	Supply chain responding to work in growth conditions	Supply chain has capacity back - get back to pre CV19 levels	Supply chain in balance with demand	Supply chain collapses as a result a slowdown in work and low demand
	Normal site restrictions	Work can continue on site under (current) SOP. Productivity begins to return to normal levels as sites adapt and find workarounds	Work on site can continue but at lower productivity levels	Tighter SOP and lower productivity
	No significant shortages of materials and labour	Materials supply return to pre CV19 capacity	Supply chain holds but ability to obtain certain materials remains difficult	Industry insolvencies reduce industry capacity
	Competitive tendering environment with fewer new schemes coming forward	Competitive tendering with more confidence in forward orders	Tight pricing in competitive market for limited number of new orders	Suicide bidding for a significantly reduced number of projects coming through
	Anticipated increase in infrastructure spending but details not yet confirmed	Work for Government infrastructure spending plans procured and work begins to commence	Most projects that have been paused/suspended resume	All spending slows further due to CV19 uncertainty
Macro/ GDP	EY ITEM Club projected GDP growth for 2020 was 1.2%	Mild and short-lived recession	GDP contracts in 2020 but makes partial recovery in 2021	Severe and extended global recession
	Brexit to go ahead but uncertainty over UK-EU trade deal and transition period remained	No further lockdowns and economic/market activity begins to resume	Government applies series of emergency brake and release measures to deal with spikes	Government support does not reach firms and cash balances are eroded
	Resilient construction output growth but new orders remained near seven-year lows	Limited output, but returning to positive growth	Improved output from current levels	Government abandons infrastructure spending plans
				Restrictive CV19 measures retained or extended for a prolonged period

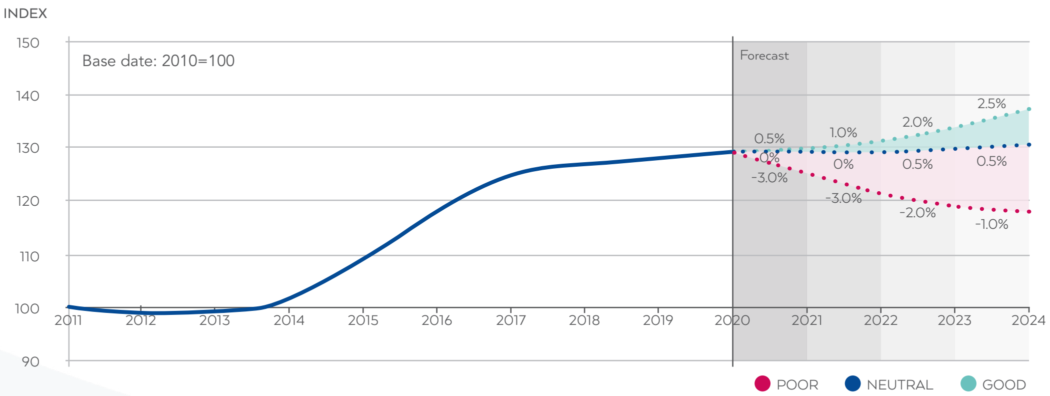
Forecasting which scenario will play out, and therefore how tender prices will be impacted, is extremely difficult. However, in the tables and fan graphs below, we provide tender price forecasts for both Greater London and the UK under each of these three scenarios. We have also provided a comparison of our UK-average tender price scenarios against the latest BCIS All-in TPI forecast.

Greater London	Q4 2019	GOOD	NEUTRAL	POOR
2020	1.0	0.5	0	-3.0
2021	1.5	1.0	0	-3.0
2022	2.0	2.0	0.5	-2.0
2023	2.0	2.5	0.5	-1.0

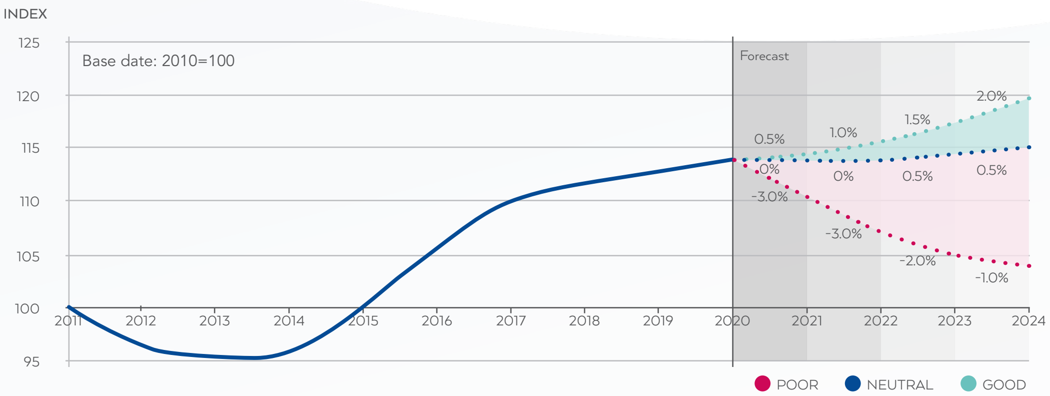
UK Average	Q4 2019	GOOD	NEUTRAL	POOR
2020	1.0	0.5	0	-3.0
2021	1.5	1.0	0	-3.0
2022	1.5	1.5	0.5	-2.0
2023	1.5	2.0	0.5	-1.0

TENDER PRICE INDICATOR

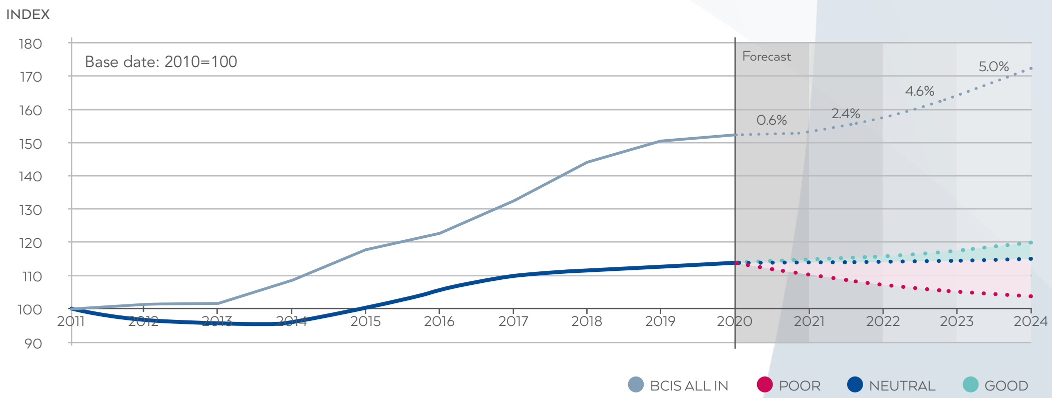
TENDER PRICE TREND **"LONDON FORECAST SCENARIO"** Q2 2020



TENDER PRICE TREND **"UK AVERAGE FORECAST SCENARIO"** Q2 2020



TENDER PRICE TREND **"UK AVERAGE v BCIS ALL IN"** Q2 2020



Our advice is to review each project on its own merits. This forecast publication must be treated as a guide only, being that it is based on averages of various types and sizes of projects across a region, ascertained through our latest market research. The quality, both of design and desired end product, procurement route (particularly ownership and transfer risk), delivery timescales, complexity of design and desire of contractors to tender should be carefully considered in project specific estimates and their outturn cost.

Suitable allowances should be made for project specific designs, site conditions and local market conditions, which should be reviewed regularly with your Gardiner & Theobald team to determine the appropriate base cost.

MACROECONOMICS

Despite there being only a limited amount of economic data to show the impact that COVID-19 is having on the UK economy, it is clear that the country is set to experience an unprecedented shock.

Global business leaders are preparing for a prolonged and drawn out U-shaped recession due to the impact of the virus, meaning that economic hardship is likely to persist until at least late 2020. Whilst economists are in agreement that the next few months will bring economic pain, there is little consensus regarding how deep and protracted the economic slump will be.

An ONS poll of 5,300 businesses found that one quarter of UK companies have temporarily closed because of the COVID-19 lockdown. The majority (55%) of those still operating have reported lower turnover than normal. Whilst the standard economic indicators showing the extent of the damage caused by the lockdown will not be available for another month, both the IMF and the OBR forecast that the UK faces the deepest recession since the 1920s as a result of lockdown measures.

Bank of England governors have said that a 35% contraction in Britain's economy in Q2 2020 predicted by the Office for Budget Responsibility (**OBR**) did not look unrealistic and warned that escaping the downturn might not be easy. The OBR's scenario also suggests that the deficit would rise to £273bn in 2020-21, 14% of national income, almost half as high again as at the depth of the 2008 financial crisis. Unemployment would soar close to 1980s levels.

Early indicators are not encouraging. Business activity across all sectors plummeted in March according to the IHS Markit/CIPS PMI indexes. Services and construction were the worst hit, dropping to 35.5 and 39.3 respectively as many service providers reported a total halt in activity and construction projects suspended work on site. At the time of writing the preliminary Flash UK Composite PMI shows that activity is expected to contract even further in April and fall to a record low of 12.9 (from 36.0 in March) - consistent with a quarterly fall in GDP of 7%. The poor survey readings will inevitably have many questioning how long the current containment measures will last.

The lockdown is costing the UK economy approximately £2.4bn per day according to the Centre for Economics and Business Research. Although Matt Hancock said that the UK has reached the peak of coronavirus outbreak, current restrictions will continue until early May, and even then we are only likely to see a phased relaxation of the lockdown restrictions and social distancing rules.

Despite Government support packages, the UK is not likely to survive many more months of a lockdown. Bill Michael, chairman of KPMG, recently told staff that at some point, we run the risk that economic disaster will transcend the human one. Striking the right balance is going to be a difficult judgement call and cabinet ministers appear to be divided over when and how to lift lockdown restrictions.

Low demand and consumer caution has contributed to falling inflation rates. Consumer price inflation fell to 1.5% year-on-year in March from 1.7% in February. However the most recent inflationary data was collected before the Government imposed lockdown measures. Inflation is expected to fall further in April, possibly to 0.5%, as commodity and wholesale energy prices fall further.

DEMAND

The pandemic has led to a historic collapse in demand across many sectors. Construction, being no exception, is also experiencing weaker demand as clients wait for the pandemic to pass.

Lower demand will undoubtedly apply downward pressure on tender pricing. Typically in recessionary periods, strong deflationary pressures are created as a result of lower demand. There is less demand for skilled labour due to fewer projects getting on site. Demand for products and materials also falls which exerts downwards pressure on raw commodity prices. Input cost deflation can create good buying windows as pure economics dictates that it is better to have some work at a lower price than no work at all.

At this point a UK pandemic-induced recession appears to be highly likely. However, there are key differences between this and previous recessions. In the last recession, the UK economy experienced six consecutive quarters of negative growth (Q2 2008 – Q3 2009). During this time the BCIS All-in TPI index fell by 12.6%. In fact, tender price inflation fell for another two subsequent quarters after the recession ended. Factoring in these two additional quarters means that tender prices fell by a total of 15.4% as a result of the last recession. The current pandemic is highly unlikely to create such a prolonged recession but it could be much deeper over the short term. For example, the worst quarter at the height of the previous recession saw UK GDP fall by -2.6% (Q1 2009). This seems relatively insignificant when compared to the 35% drop in GDP that both the OBR and BoE are suggesting is possible in Q2 2020. However, as per our poor scenario above, should we be inflicted with a second wave of CV19, demand will be further reduced leading to a prolonged recession. This, like the whole CV19 outbreak is unprecedented.

Although it won't be instant, demand is likely to return relatively quickly compared to previous recessions once the lockdown ends and social distancing restrictions begin to ease. There will be a release of pent up demand and one of the challenges will be ensuring that supply can keep up with demand in a recovery.

PIPELINE

Although work has stopped at 29% of all UK construction sites (accounting for 64% of the value of work currently under construction), Glenigan reported a significant increase in detailed UK planning approvals in March compared to any of the previous 12 months. This is positive for the long-term project pipeline, but the short-term project pipeline is faring less well.

Data from Barbour ABI shows that contract awards in March were weak, falling to £3.8bn from £7.6bn in February. Furthermore, many of the contracts awarded in March have now been put on hold. However, in the first quarter of the year the total value of contract awards were 26% higher than the previous quarter and 17% higher than Q1 2019. Before the pandemic hit the UK was clearly experiencing improving demand conditions in the wake of the General Election result and a positive March 2020 Budget.

However, the lockdown measures, which came into effect on 23rd March, prompted sites to take a variety of approaches in response, from temporarily closing all sites to continuing work after conducting internal reviews and putting new protocols in place. It has since been confirmed by the Government that work on site in England is permitted providing the Construction Leadership Councils (**CLC's**) Site Operating Procedures and Public Health England guidance on social distancing is followed.

Lockdown restrictions have certainly had an immediate and severe impact on projects currently on site but the long-term development pipeline looks encouraging. The current uncertainty has inevitably led to a fall in new enquiries which will hit the project pipeline in the short term, but projects at the design stage are proceeding. Most work in pre-construction also appears to be proceeding as planned but is often pausing or stopping at the end of a work phase.

GOVERNMENT GIVES CONSTRUCTION THE GREEN LIGHT

Keeping sites open has become an economic imperative for both the Government and construction firms. However, for this guidance to have the greatest effect, the whole construction supply chain needs to be operational and working collaboratively. Most builders' merchants have responded to lower demand for materials by reducing production capacity and offering only a partial service. To help keep supply chains moving and ensure that parts and raw materials are available, the Department for Business, Energy & Industrial Strategy (**BEIS**) issued a letter to those working in manufacturing and industry in the UK, asking for the industry to keep supply chains moving. Building material manufacturers such as Michelmarch are beginning to restart production at their plants, partly because of such encouragement from the Government. New BMF 'Branch Operating Guidelines' will also provide some reassurance to builders' merchants looking to resume operations safely during COVID-19 restrictions.

The Government has made it clear that it considers construction to be a critical part of the UK economy and is keen to support the supply chain. Notice to proceed orders have been issued by the Department for Transport to the four main works civils contractors (**MWCC**) behind Phase One of HS2, providing an immediate boost to the industry. Nadhim Zahawi, Under-Secretary (**BEIS**) is also speaking with other government departments to identify construction projects that could be accelerated or brought forwards, noting that, "...in terms of prompting the economy to incentivise growth, infrastructure is incredibly important. Greenlighting such projects will give contractors and the rest of the supply chain confidence in a recovery and may help kick-start on-site activity".

SUPPLY

Whilst a recovery in demand is expected to be U-shaped, some forecasters suggest that supply could be L-shaped.

At the moment, many manufacturers have reduced production capacity but are still actively supplying projects. To return to full capacity they will need to be confident that sufficient demand has returned and is sustainable. Otherwise they run the risk of having to stockpile unsold products and cut their workforce.

Some anticipate that cash-strapped suppliers will start to struggle in the coming weeks and so contractors are considering whether they can prop them up or buy stakes in such firms in order to keep them afloat and prevent potential collapse. Contractors are concerned that sites will be unable to restart because trade contractors and materials will not be there. Consequently, several main contractors are considering the possibility of buying up parts of their supply chain in order to keep schemes running.

As with previous recessions, some insolvencies are inevitable. The Government's Business Interruption Loan and Job Retention Schemes will help mitigate insolvency risk and allow many contractors to weather the storm, but if there is a failure of a significant number of sub-contractors, it will have an immediate and negative impact on projects. Any insolvencies will also lower industry capacity, reduce tendering competition and put a certain amount of upwards pressure on tender pricing.

Almost all contractors have furloughed a portion of their workforce. As more sites open will it be difficult to get these workers back on site? Fewer operative numbers will likely mean lower output and higher costs. However, countering this, a reduced on-site workforce may make recruiting skilled labour a little easier and push down labour wages

Housebuilders such as Taylor Wimpey plan to restart work on sites but say that it would take until at least June to reach 80% of normal activity levels. Full capacity isn't expected to return until 2021. Contractors, such as Mace, appear to be working to a similar timeline. For some, on site productivity is currently is only 10-15% of pre-COVID-19 levels but many plan to ramp this up to over 50% over the coming weeks.

Tier One Contractors in the London market have mostly established plans to keep their sites open and maintain output whilst keeping their workforce safe in accordance within government guidelines. New project operating plans to increase resilience are being put in place which cover the movement of people on-site as well as providing new working practices for both management and the workforce. Measures such as enhanced cleaning, staggered working, temperature checks and no unauthorised visits have been implemented.

The CLC's Site Operating Procedures (which require a distance of 2m to be maintained between workers where possible) will hamper productivity for as long as it's in force. There will be some innovative and creative changes to working procedures, such as split shifts and this will help with productivity but it will take time to adapt. Larger sized welfare and loading areas will be required, adding cost to adapt existing or higher costs for new projects. In the short-term, lower productivity and changes to preliminaries will manifest themselves in programmes and tenders.

Finally, the impact of backlogs needs to be considered. If demand picks up quickly and industry capacity is diminished as a result of delays to projects and extended schedules, this could provide upward pressure on tender prices.

HOW DOES CONSTRUCTION EMERGE FROM THE PANDEMIC?

A number of proactive steps have been taken to help the industry emerge from the pandemic.

- The Competition and Markets Authority (CMA) has said it will allow firms to work together to support the fight against coronavirus, providing any coordination between competing businesses was, "undertaken solely to address concerns arising from the current crisis and not go further or last longer than what is necessary". The CMA warned that it would not tolerate conduct which opportunistically seeks to exploit the crisis and would take enforcement action to prevent consumer detriment, but relaxing its stance could help support the supply chain.

- The trade body Build UK confirmed they are in talks with the Local Government Association to extend permitted site opening hours to help make up for lost time as a result of site closures. Longer working hours would allow contractors to improve safety by reducing the number of sub-contractors onsite at any one time. It also staggers canteens and sign-in books.

- CLC's SOP have clarified that tasks which require workers to be closer than 2m should last no longer than 15 minutes "where possible" and recommends additional supervision. The guidance means that a greater number of tasks can be performed safely on site.

- Unprecedented Government financial support, including grants, loans and tax relief to help businesses maintain cash flow.

- The Construction Leadership Council task force is looking into alternatives to invoking contractual clauses which are likely to be detrimental to the supply chain.

- Cabinet Office published supplementary guidance notes for construction contracts to support contracting authorities in implementing PPN 02/20 - supplier relief due to Covid-19. To be eligible for relief, suppliers must operate on an 'open book' basis, continue to pay their employees and supply chains promptly and warrant that they will not be in breach of any financial covenants by accepting the relief. Public sector clients can provide relief such as accelerated payment of invoices, more regular payments, advance/pre-payment(s) or payment on order. Authorities can also consider early release of retentions.

- Companies House has temporarily paused the strike-off process to give companies affected by coronavirus the time they need to update their records and help them avoid being struck off the register. This follows the previously announced three-month extension to file accounts with Companies House.

- CLC's encouragement of collaborative working to avoid costly disputes which may result in insolvencies.

- Contractors have refocused on off-site productivity and design to keep projects on track. Modern Methods of Construction and innovation will play more part in maintaining productivity whilst social distancing continues, these could then become the new normal.

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