Impact of COVID-19

2020-2021 Market Forecast

MARKET SUMMARY

An early 2020 post-election industry resurgence offered welcome respite from protracted Brexit withdrawal discussions. However, this was short-lived following the arrival of COVID-19, leaving us all with the current unprecedented trading conditions and uncertain outlook, but there are opportunities…

This forecast looks at the impacts over 2020-2021 rather than forecasting too far into the unknown

How is the Market Responding to the Pandemic?

After Initial government ambiguity around the closure of sites (in contrast to Scotland's closure of all 'non-essential' sites) and **by stealth, we are seeing the industry re-engage after a short period of lockdown.**

A small proportion of sites remained open throughout as either a function of the status of the site (i.e. early groundworks or frame) or as a precaution and in fear of being 'hit by the Contract' and jeopardising programmes.

Many businesses throughout the supply chain have had to furlough staff to stay afloat and conserve cash whilst the **knock on supply capacity impacts appear to be significant on existing live projects.**

These unseen impacts of restricted travel, Site Operating Procedures (SOP's), availability of materials, Contractual claims, business failures and reduced market liquidity are still in their infancy and will need to be closely monitored.

Contractor's will have signed up to programme's based on a maximum physical site presence (contravening SOP's) and on an assumed conveyer belt of available materials.

Stop-start progress and watching eyes from the HSE / CLC will also require **accurate and proactive management to mitigate delays and claims. Government interventions for longer working days and weekend working will help.**

Has there ever been a more opportune time to drive off site construction in the industry?

Demand vs. Supply Shocks

UK wide demand and supply shocks have been hugely significant, namely;

- BoE estimates a 14% 2020 GDP contraction
(direct link between GDP & construction output)
- 27% of UK workforce furloughed (ONS)
- 7 to 10 million likely to be on furlough
- 10% + unemployment a probability
- Biggest GDP contraction since 1706

Similarly to historic GDP crashes (shown overleaf the correlation with 2008 & late 80's GDP shocks) **our view is the demand shocks will be greater than the supply, resulting in a deflationary tender price forecast of -6.25% over the next 12 months (see overleaf).**

The extent of price movements beyond 12 months will very much depend on the recovery profile (see overleaf - 'V', 'W', 'U', 'L', 'tick') and our ability to contain the 'R' value to suppress further 'sombrero's'.

Green Shoots of Recovery?

It may feel slightly premature but agents have reported a spike in activity from investor developers and funds on the lookout for good quality sites at reduced prices. Distressed retail portfolios are giving opportunities to regenerate high streets with mixed use masterplans.

One of the most fundamental questions is how much will the government be able to re-invest in national infrastructure programmes (already committed to HS2) and achieving house building targets when they have spent £300bn+ on COVID19 measures.

How are Contracting Parties Interacting?

In the most part we are seeing measured, reasonable behaviours between Employers and Contractor's in an attempt to;

- Encourage ongoing information sharing
- Avoid initial unhealthy adversarial stances
- Mitigate supply chain insolvency risks
- Protect company reputations
- Get to the finish line with a quality product

In other instances we are seeing Parties Contractually protect their positions in an attempt to mitigate their claims risk exposure.

The CLC and Cabinet Office have recently issued guidance on responsible Contractual behaviour (7th may).

Our Approach to COVID19 Tender Price Forecasting

We have taken a **bottom-up approach to formulating our 12 monthly forecast which scrutinises the consistent parts of a contract sum in parallel with;**

- known market movements
- macro commodity & currency fluctuations
- supply chain intelligence
- central government policy / interventions
- reference to historical GDP shocks

Our exposure to various sectors and geographies has enabled us to also provide insight into Regional Buildings & Transport and Infrastructure as well as London Buildings.

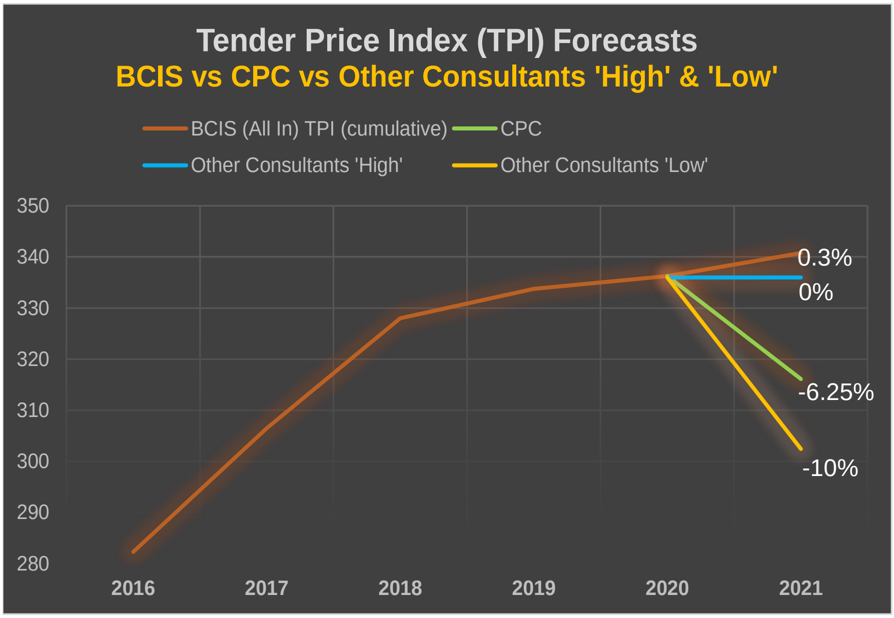
Also see our sector focused outlook for insight into specific sector market dynamics.

TENDER PRICE FORECAST LONDON & SOUTH EAST

We have modelled the key component parts that make up a contract sum, based on a range of project values, and considered ↓ **downward** and ↑ **upward** pressures (shown below) to form our **short term forecast of -3.5% tender price deflation by the end of the year and -6.25% in 12 months (Q2 2021).** It is important to note that these deflationary forecasts are **based on new projects yet to be tendered and not live projects.**

We believe the **following key inflationary pressures will counter more severe deflationary forecasts** (similar to trajectory's experienced from previous market crashes);

- **reduced supply chain and manufacturing capacities** bringing possible price control mechanism's
- **impacted site productivity / logistics** associated with adhering to Standard Operating Procedures (SOP's)
- **security in delivery** and a preference for those with vertically integrated models or inhouse capabilities
- **reduced net migration** countering a possible over supply of labour.
- **increased traction in off-site manufacturing and modular solutions** to safeguard delivery models.



Live projects on site are more likely to experience increased cost pressures associated with lost programme time, SOP impacts, reduced opportunities to recover time or accelerate, a race to secure scarce materials and remobilisation inefficiencies. Likelihoods of commercial stresses between the parties (incl the supply chain) have increased as the **contractual and financial 'pain' associated is apportioned**, and so it is critical that all parties collaborate to focus on completing their contractual obligations whilst minimising the risk of supply chain failures.

The following key ↓ **downward** and ↑ **upward** pressures have been modelled against their associated cost apportionments to form individual % price movements, for new projects, to Q2 2021;

Labour & Prelims
-5%

↓ Stuttering demand will increase supply competition for new work (extent dependant on central government public sector stimulus)
↓ Workforce willingness to get back into employment
↓ Preliminaries management costs running at 10-20% reduced salaries for a protracted period of time
↓ SOP's resulting in less personnel on site and again increased supply pricing competition

↑ Extent of labour deflation will be subject to the extent of returning EU workers
↑ Our forecast is based on a manageable impact of SOP's with productivity being impacted by no more than 20-30%. Site specific conditions and H&S management will all impact the extent of inefficiency & cost

Materials & Plant
Inc commodities
2.25%

↑ Surge short term demand increasing the risk of price hikes
↑ Availability shortages will be borne from reduced manufacturing capacities as factories have been closed and SOP's reduce the volume of production labour (evidence of prolonged factory furloughing)
↑ Contractor relationships with the supply chain will be key to leverage prioritisation
↑ Greater traction and adoption of offsite manufacturing and modularisation
↑ Weaker Pound along with risk of import duties and inflation from EU countries post Brexit withdrawal
↔ Assuming the EU summer shutdown will be cancelled to avoid greater surge demand
↓ Global commodities decline partially offset by cross boarder agreements to control production

Margin
(MC & SC's)
-2%

↓ Contractor's will focus on preserving cashflow and securing pipeline in an uncertain market place, especially as projects previously in their pipelines are mothballed or postponed

↔ Increased Contractor due diligence around Client behaviours in dealing with post Covid19 claims. Increased Client due diligence around risk of business failure associated with rock bottom margins

↑ 'Tier 1' Main Contractor's & Sub Contractor's may steer away from repeating mistakes of the past and chasing revenue at low margins and therefore hold their positions at risk of business shrinkage

Risk
(MC & SC's)
-1.5%

↓ General acceptance that margin and risk aspirations for the immediate years post Covid19 are reduced and revenue and workforce stabilisation is a priority over margin and risk pricing

↓ Anecdotal evidence of Main Contractor's increasing their inhouse supply chain capability through acquisition, which will in theory reduce their level of risk as greater delivery control is achieved

↑ Assuming a Client side legal / contractual 'tightening' of clauses, particularly around force majeure, would attract an increased risk premium from the market

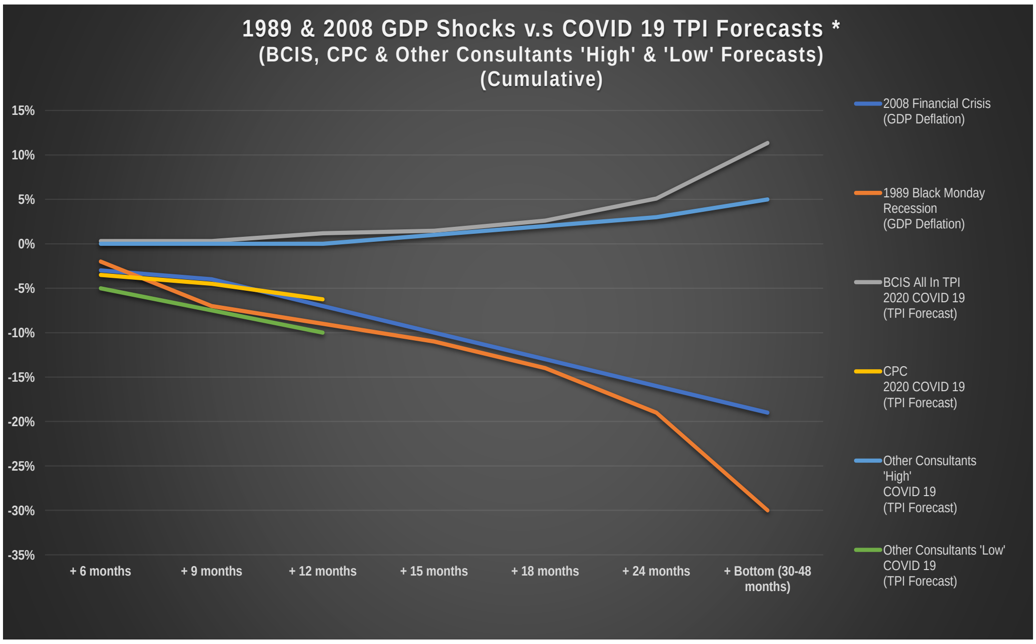
HISTORIC GDP CRASHES & RECOVERY SCENARIO'S

When assessing the various recovery scenario's **we took reference from previous market crashes** (namely Black Monday in the late 80's / early 90's & the 2008 financial crisis) **to draw relevant parallels and lessons learnt.**

* It is widely regarded there is a **direct correlation between construction output and GDP and similarly a knock-on relationship between construction output and tender prices.**

We have graphically presented how our forecast relates to the referenced historical crashes and the disparity to current projections from the BCIS and some other industry consultant firms.

Although **we have used demand and supply shocks as part of the basis for our forecast, the profile of any GDP recovery will be a determining factor in the industry's ability to recover and regain confidence.**



The government's ability to **keep a foot on 'the sombrero' and control the 'R'** to manage any further spikes will **play a huge part in the construction industries resurgence and speed to recovery**. We have looked at the following recovery profiles and their associated impacts on the industry;

Historically market downturns have generally followed this recovery trajectory, where the market bottoms out and rebounds to pre-crash levels. **Variants known as the 'tick' or the 'swoosh' are increasingly being tabled by economists as a realistic recovery model post COVID19**, provided multiple spikes in cases / lockdowns are avoided.

Our view is a 'V' shaped recovery from this pandemic feels too optimistic but an 'L'-shaped view is probably too pessimistic, therefore leaving us with a realistic middle ground of a 'tick' type recovery. A sluggish rebound, high debt burdens and pressured development appraisals will temper construction demand and result in a prolonged shallow ascent to previous output levels.

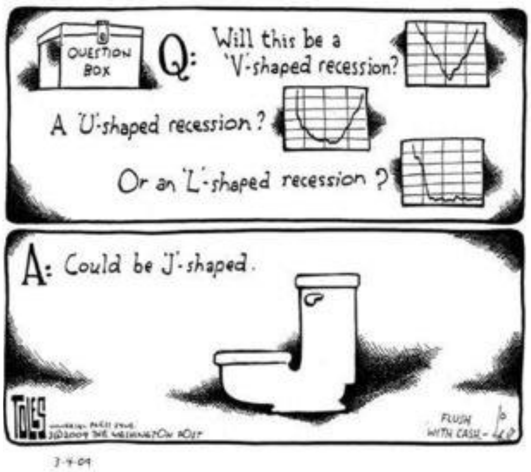
This 'double dip' recovery model is **more likely if the virus continues to linger and the UK experiences repeated stop-start lockdowns** of various extents before the market starts to rebound.

Whilst there may be a release of pent-up demand driven in part by government stimulus, repeated virus resurgences will further dampen businesses ability to return to pre-crisis productivity levels.

Central government measures implemented to date along with tracking the performance of other countries slowly releasing lockdown measures, **appears to suggest that a cautious approach to exiting lockdown may hopefully avoid this 'double dip' scenario.**

This **'L' shaped recovery scenario is the most catastrophic** whereby the economy takes multiple years to recover, decline or even collapse.

A **lack of vaccine or drugs for a number of years could prolong any depression** resulting in record low levels of liquidity, suppressed growth and unemployment highs. Central financial stimulus would be absolutely essential in avoiding a 'declining L'.



We are **closely tracking the market and recovery progress of other countries** a number of weeks ahead of us in the pandemic.

The UK's construction output and TPI is strongly linked to the **supply of labour and materials beyond our borders and therefore the global recovery trajectory will directly impact our ability to return to any kind of productivity norm.**

The result of this global tracking will be factored into our next market update.

DEMAND & SUPPLY SHOCKS 2020-2021 OUTLOOK

Our view is that in the **immediate term (6-12 months) demand shocks to the construction industry will generally outweigh supply shocks as investment appetite weakens and liquidity levels are at record lows**. The global nature of the pandemic will dampen investor desire to enter new markets and sectors, particularly as consumer demand across sectors continues to fluctuate. We have tabled below some notable demand and supply shocks which have been factored into our 2020 tender price forecast;

KEY DEMAND SHOCKS

- **OBR estimates 14% 2020 GDP contraction. (Direct link between GDP & Construction output)**
- **Biggest quarterly contraction since 1908**
- **2% GDP drop/each month in lockdown (OEDC)**
- **Corporate debt ratios at an all-time high**
- **£300bn+ stimulus will dampen governments ability to reinvest in capital programmes**
- **Collapse of rental income across multiple sectors will dent private reinvestment cashflow**
- **Transactions have ground to a halt with values severely dented across sectors**
- **Global investment confidence at an all-time low**
- **Negative bond yields indicate global investors are expecting a substantial recession**

KEY SUPPLY SHOCKS

- **Between 7-10 million workers are expected to be furloughed costing £30-£40bn over 3 months**
- **Unemployment rates are expected to rise from 4% in Feb 2020 to 10-15% by Q3/Q4 2020.**
- **Construction is the 2nd highest sector utilising furlough, totalling 32% of workers (ONS)**
- **70%+ of the construction industry has continued to trade throughout the pandemic**
- **Few business failures recorded to date but expected to increase as commercial tensions around contractual responsibilities play out on site**
- **Cashflow will be paramount despite tax deferrals**
- **Construction manufacturing output at sub 50% capacity driving a spike in demand for materials.**

Site Operating Procedures (SOP's)

The Construction Leadership Council (CLC) have issued version 3 *(14th April)* of their SOP's which provide guidance on the following;

- When and how to travel to work
- Site access and egress points
- Hand washing
- Toilet facilities
- Canteens and rest areas
- Changing, shower and drying areas
- Cleaning
- First aid and muster points

Materials & Distribution Supply Shortages

Demand is far outweighing supply for certain materials, resulting in suppliers prioritising end users and posing additional productivity issues.

Although some suppliers have started to remobilise, pressure remains on the following;

- Plasterboard
- Bricks
- Mortar
- Internal doors
- Steel lintels
- PPE (masks which are now req'd)
- Hard landscaping

Distribution of materials is affecting productivity as essential sites are rightly prioritised.

It is critical Clients & Contractors are readying themselves for swift re-sourcing of materials through efficient planning and procurement.

SECTOR FOCUSED 2020-2021 OUTLOOK

Our cross sector exposure enables us to form an informed view on 2020-2021 outlooks post the 1st peak of the pandemic. **We have already seen responsive urgent action from our Clients in safeguarding their investments and we consider how consumer demand will play a central part in driving operating models for the various sectors.** Although these are unprecedented times we have already started to see some common trends across sectors.

Retail

The **polarisation of the retail sector continues to accelerate** and the COVID-19 lockdown has highlighted the further divergence of this sector. Food stores and the convenience sector have traded strongly throughout. Early research is also **indicating a return to previous shopping trends with one weekly shop being carried out per household**, largely due to the government restrictions. With online delivery at its capacity in this sector, it is highly possible that the move to online food sales may see physical retail sales not return to their pre-lockdown performance.

The **digitisation and showrooming of physical stores that had been seen in the non-food sector is likely to accelerate faster**. The sector needs to anticipate and prepare for a significant shift in consumer behaviour, with customer toilets, changing rooms and leisure facilities coming under much greater pressure. **We anticipate that many high performing retailers will review current store portfolios and utilise the lockdown period to re-open stores on a phased basis**, with lowest performers potentially remaining closed for good.

Commercial

The office market has been very resilient, especially in London but with offices lying dormant or operating at half capacity, the outlook for the sector could change.

The longer white collar professionals work remotely from home and demonstrate similar or higher productivity levels to offices, the greater the risk of a significant drop in demand for new space. Large tech corporates such as Twitter and Google have challenged the extent to which they will return to the traditional office model, while a few **developers have already elected to defer capital spending for office schemes at ground floor and above to wait and see how occupier sentiment plays out.**

The **market should remain for the best located schemes**, while in London there is a narrow window of opportunity to submit planning applications before a transition to a more onerous suite of policy conditions.

Meanwhile, the **health and lifestyle benefits of reduced commuting may see increased uptake of smaller regional enterprise centres** offering flexible workspace and ample cycle storage and on-site amenities to boost investment in local employment and communities.

Residential, BtR & Hotels

Until last week housing market **transactions had ground to a halt**, **sales values are expected to take a short term downturn of between 5-20%** (Savills & Knight Frank) and general **market confidence has been eroded** since the early gains at the start of the year. We are seeing a **spike in opportunistic land buyers trying to secure land at reasonable prices, particularly distressed retail assets that pose mixed use opportunities.**

The **RICS has called for stamp duty holidays** to help stimulate the market and there is the **hope that a rock bottom 0.1% base rate will result in enticing mortgage rates** (if the banks adjust accordingly). The emergence of the **Build to Rent (BtR)** sector is **facing new challenges around weakened consumer demand** driven by the change in mindset away from shared amenities.

Demand for **hotel and leisure investment will be impacted** by a reduction in global travel by businesses, while consumers focus on household essentials rather than tourism.

Central financial stimulus from government is required to support affordable house building to hit minimum annual targets.

Healthcare & Education

Typically, the higher education projects that are underway, are set to continue but under close management of social distancing and other revised working guidelines. Projects in their **precontract phase are now subject to additional gateway review measures** in light of the need for increased financial scrutiny. Projects in their infancy may be slower to commence or may be postponed until the impact on student numbers and demand post COVID-19 is fully understood.

A number of our clients are thinking opportunistically, **undertaking essential maintenance on busy campuses whilst occupation levels are uncharacteristically low**.

The **agility and capability the health sector has shown amidst the currently crisis is contrary to its everyday archaic and bureaucratic approach to capital planning** and might provide justification for future improvements in process and procedure.

The **governments commitments to building additional hospitals and significantly upgrading a number of existing** hospitals will stimulate the sector and long term healthcare infrastructure.

The current crisis is also likely to see a **requirement for further temporary healthcare accommodation** before the pandemic subsides.

Industrial & Logistics

The **big box warehousing market is perhaps one of the least impacted sectors by the COVID-19 outbreak**, with many of the major UK landlords reporting high levels of rent collection at the March quarter date.

Many **industrial agents have been reporting an increase in demand for warehousing space** as retailers and other businesses look for storage space for surplus stock as well as a significant upscale and upsizing of online business.

The outbreak has cemented the requirement for warehousing space near to urban locations and in particular the requirement for new, sophisticated and well-built facilities.

The last mile delivery focus in the recent few years for urban locations for smaller delivery hub warehousing is also likely to increase in the short to medium term.

With reports that **the majority of prime warehousing space in the UK is almost fully let, this sector is forecasted to continue to grow.**

Transport & Infrastructure

With ridership down on London's Tube and Buses by 95% and 85% respectively and predictions that rail operators across the UK will be limited to 12-22% capacity due to social distancing the outlook for the transport sector looks bleak. With the Government already funding Crossrail to the tune of an additional £2bn and calls for a further £2bn to finance a blackhole in TfL's budget the Treasury is under pressure to keep the sector afloat. Governments support to remobilise HS2 will provide partial relief to its vast supply chain.

The same cannot be said for the UK's airports, with the **decision not to proceed with the new runway at Heathrow and Gatwick Airport forecasting that it will be at least 36-48 months for passenger numbers to return to pre COVID-19 levels**. Impacts on this sector will be compounded by plans to quarantine passengers flying into UK airports for 14 days and the recent news by British Airways that it is unlikely to resume services out of Gatwick.

In a more positive vein Highways England are continuing with their road building projects, including the deployment of the new Intelligent Transport Systems (ITS) programme and the initiation of a £3.6bn, six year Operations Scheme Delivery framework, focused on new projects, improvements and maintenance works across the UK.

REGIONAL FOCUS 2020-2021 OUTLOOK

Our 7 UK offices give us a strong platform to capture and share; local market insights, relevant and current data and localised supply chain knowledge, whilst delivering consistency for our multi-region Clients. Below we focus on some of the regions in which we operate.

Manchester & Liverpool

Supply shocks have the potential for greater impact in the North West as there are generally less Contractors and suppliers, proportionately when compared to London & the SE, to the number of opportunities available. Over recent years, pre COVID-19, we have seen a number of business failures which have further exaggerated supply chain shortages.

The virus will add to the risk that supply shocks may tip the balance with demand shocks.

With regards to Sectors prior to COVID-19, the **residential sector was very active in the region with over 15,000 units and upwards of 2 million ft2 of new commercial office space under construction. The hotel sector was buoyant, with nearly 2,500 beds under construction**.

As residential units continue to complete in Manchester City Centre, new supply will start to tail off and the City would usually look to increase its commercial offer to create a more balanced environment. This may now have a number of challenges as the requirement for commercial work space is in question like never before.

Liverpool is also a buoyant market which has attracted significant international investment, particularly in the residential sector. **Liverpool has some major town centre redevelopment schemes on the horizon that will reinvigorate the City and attract further investment.**

With new Government spending commitments in the North, there is a positive feeling that construction activity is still likely to increase, predominantly in the health and infrastructure sectors. However, the extent of private developer investment in the immediate term post COVID-19 is likely to be impacted until confidence returns to the markets.

There will be an anticipated / expected period of turmoil as Contractors and Sub Contractors wrestle with Claims, restarting projects and new work orders.

The availability of materials now and post COVID-19 will again bring stresses and strains to the construction environment. This will feed into pricing for new tender opportunities.

Contractor's solvency is a critical issue and the industry in the North West needs to work together to avoid further business failures. The risk on site productivity impacts around SOP's will likely need longer working hours to recover programme time lost.

Yorkshire & Humber

As with Manchester and Liverpool, the biggest threat to the supply chain is Contractors solvency. Only recently, regional based Contractors have ceased trading and had administrators appointed, due to difficult conditions arising from projects being postponed or cancelled. **Infrastructure commitments such as HS2 and the Infrastructure Improvement Strategy will support the supply chain and local labour markets**

In Yorkshire, a number of industrial, residential and commercial office schemes have made the positive decisions to proceed, following recent gateway review milestones.

Infrastructure remains active, with ongoing work improving transportation links.

Development of student accommodation across Sheffield, Leeds and York together with further cities such as Nottingham within reach is also continuing. However, initial discussions are being held on adopting alternative web based delivery programmes, in part, which could impact the sector.

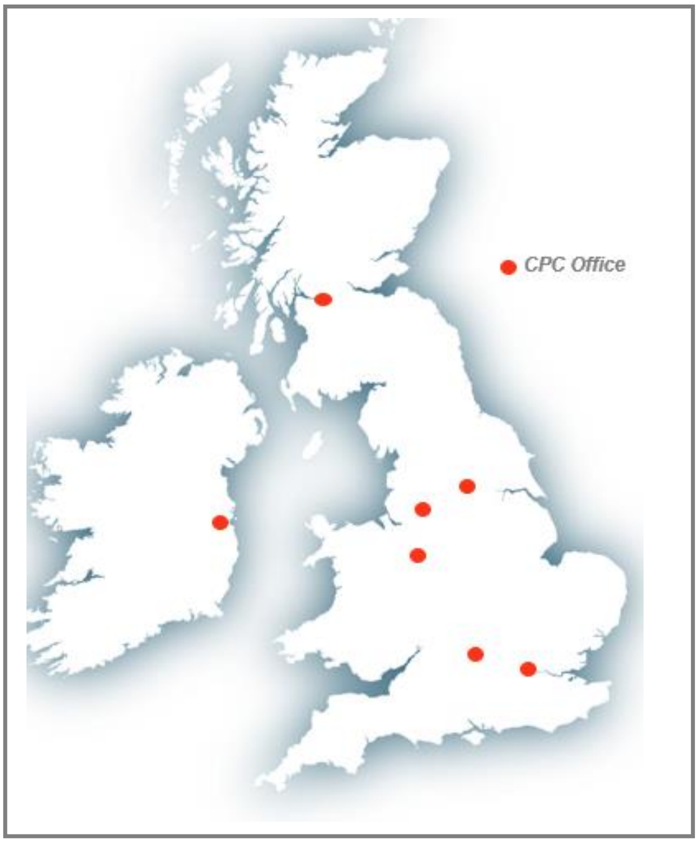
Meanwhile, the retail and leisure sectors face the challenge of reduced levels of investment from some large operators.

Given the geography it is an ongoing struggle to maintain a localised skilled labour force (even without impacts such as Brexit net migration erosion and quarantining measures) with many trades heading south or internationally. As demand across the UK is under strain there may be a slight rebalancing of labour.

Pre COVID-19 tender prices were rising, due to increased input costs, but more significantly due to skilled labour shortages. Buoyant economies in central Europe were previously attracting labour from the region, such as bricklayers and joiners. Restricted travel and expected reductions in net migration will challenge this historic pattern and put greater pressure on labour rates.

While the Government has set itself an ambitious target to build 300,000 homes every year in England alone, we collectively need to incentivise the labour market to remain within our shores.

With the end of the Brexit transition phase looming, we need to take account of the worsening construction skills shortages. The immigration system that replaces free movement of people will have to accommodate the particular needs of the construction industry.



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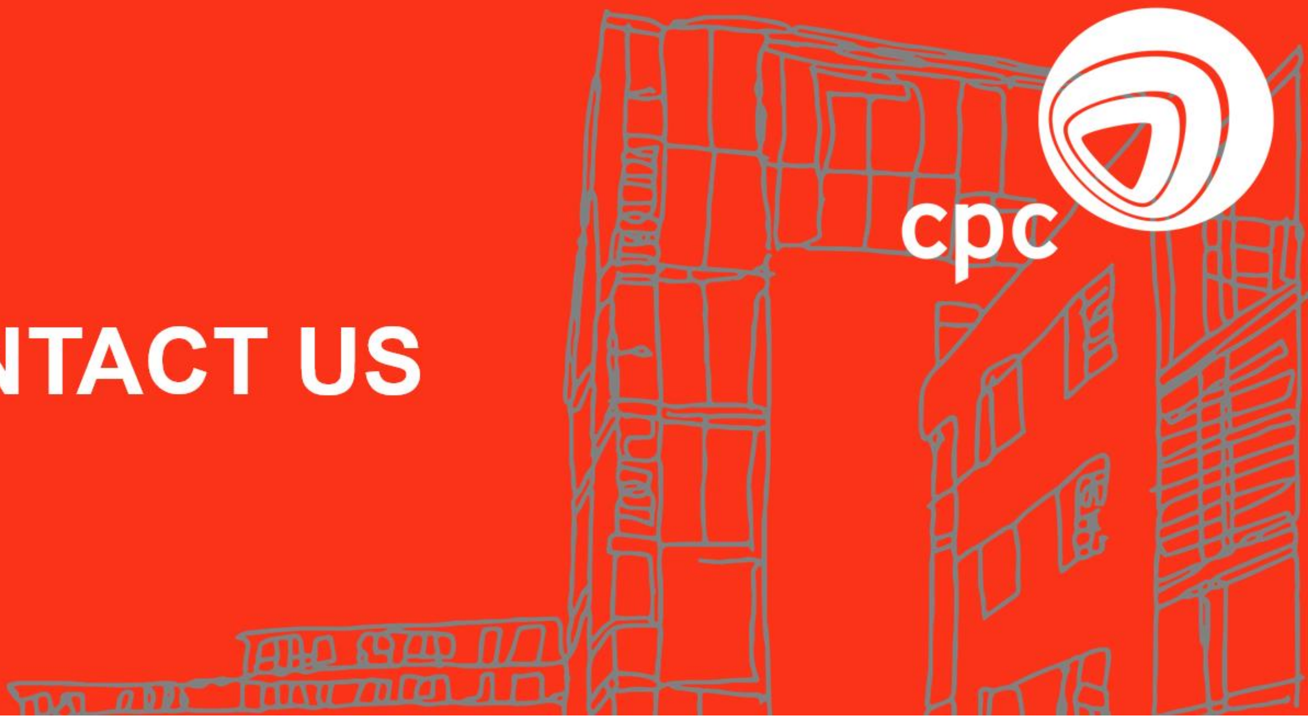

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We are proud to be an independent company owned and operated by our Partners, with no controlling parent or shareholders.

The majority of our work (80%) is repeat business and we have seen healthy sustainable growth over the last seven years.

We have extensive experience in Residential, Commercial, Transport, Health, Education, Retail and Local Government sectors.

FACT FILE

ESTABLISHED:	1990
STAFF:	209
UK LOCATIONS:	7
TURNOVER:	£24.4m
RANKING:	1st*

*Largest specialist consultancy for Project Management in the UK (source: Building Top 150 consultants, 2019)

If you would like to discuss the content of this report and how we could assist your business in these challenging times then please do not hesitate to get in touch with any of the authors, shown below.

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