Turner & Townsend alinea

Good intentions

London market report

November 2024

We transform together.

Summary

It feels as if everything has changed, yet nothing is substantially different.

The newly elected Labour government arrived with a promising mandate, but it is still gearing up to kickstart its initiatives. Similarly, both consumer and business confidence are waiting to be lifted.

Speculation about the state of public finances and 'black holes' has cast a shadow over any hopes of an immediate post-election economic upturn that typically follows a new administration.

Whilst there are positive indicators in the economic outlook, there always seems to be a 'but':

- Inflation is under control, but core inflation remains worrisome.
- The global economy has shown resiliency, but the tension in the Middle East is deepening.
- Sentiment in the construction sector is on the up, but the pipeline of work is yet to meaningfully harden.
- The US economy is strong, but there are concerns of a 'hard landing'.
- Contractors are keen to secure the right projects, but they are more risk-averse, selective, considered and aware of supply chain pressures.
- Demand is good for the best real estate product, but these can be expensive, due to higher specifications and a sustained drive for exemplary ESG.
- Material prices have stabilised, but at higher levels and there is volatility in certain commodities such as copper, and others may be affected by conflict in the Middle East.

All the optimism appears to be counterbalanced by risks that mean a returning construction pipeline may come with difficulties. These opposing forces, and the lack of any meaningful change in market dynamics, have encouraged us to maintain our previous forecast for tender price inflation – there is simply no demonstrable evidence for us to revise our forecast at this point in time.

We have maintained our forecast for tender price inflation in London during 2024 at 2.0 percent, with an increase to 3.0 percent in 2025.

This is not to say that everything is gloomy, the industry has always been full of good intentions, and it is time we acted on them in earnest. The honest and careful approach by the supply chain to tendering opportunities should not be criticised in an era of business failures and projects that over the past few years have not moved forward as quickly as expected. It is to be hoped that such honesty breeds good practice and trust across teams and provides encouragement to the best practice and collaborative behaviours promoted by Trust and Productivity – The Private Sector Playbook.

Overall economy

2024 was thought to be the year that full confidence returned to the markets, with falling interest rates, an energised new government, and stability in the material markets. So, what has changed in the last six months?

Economic overview

Following a year of near-stagnation in 2023, the UK had a strong start to 2024 despite downward revisions to gross domestic product (GDP) more recently (Figure 1). The UK economy has continued to recover from the recession at the end of 2023, albeit at a slowing pace. The economy is expected to lose momentum throughout the second half of 2024, with growth in domestic and business spending replacing government investment.

Slowing inflation, combined with pay awards, has meant real wage growth of 3.0 percent in the year to May 2024. There are, however, concerns that this has not been a catalyst for increased consumer confidence. Households seem to be building a 'rainy day fund', as household savings have increased to the highest level since 2021. At the same time, the Lloyds Bank Business Barometer showed that business optimism is weakening. The General Election pushed it to an eight-year high, but it has since fallen, with the balance of economic optimism amongst surveyed companies falling to 38.0 percent, the lowest since March.

Slowing inflation

The rate of consumer price inflation (CPI) has significantly slowed after peaking at 11.1 percent in October 2022, the highest rate in 40 years. It is now almost at the Bank of England's target of 2.0 percent, suggesting that inflation has been largely controlled.

Higher interest rates have slowed increases, but the Bank of England has warned that inflation is likely to rise in the near term as declines in energy prices fall out of the annual comparison. This reveals some of the domestic price pressures that could push CPI closer to 3.0 percent. Core inflation (which excludes energy, food, alcohol, and tobacco) is currently 3.6 percent and increased last month.

Although the CPI's easing has been welcomed, prices are still significantly higher than they were at the beginning of 2021.

Growth prospects

The Organisation for Economic Co-operation and Development's (OECD) September report saw that the global economy has remained resilient in the first half of 2024. Accommodative monetary policies around the world and improving real incomes (income adjusted for inflation) are expected to create steady growth of 3.2 percent in 2024 and 2025. It described economic growth in Britain as 'robust' in September and upgraded its expected growth rate from 0.4 percent in May to 1.1 percent, with a slight increase to 1.2 percent in 2025. In its May forecast, the UK was behind all other G7 nations (Figure 2), whilst now it is on a par with Canada and France, though still behind the US. Yet, the UK is expected to experience the highest rate of inflation of any of the G7 nations.

Much of the UK's inflation has been a result of global supply chain pressures rather than driven by domestic demand. These are expected to continue, with geopolitical tensions posing a significant risk to global economic activity and inflation. Close attention is being paid to the oil markets, acknowledging the increasing tensions in the Middle East. At the beginning of October, oil tankers were reportedly avoiding Kharg Island, which handles about 90.0 percent of Iran's oil exports. Additionally, the outcome of November's US election will determine whether further tariffs will be imposed on goods imported into the US, a policy President Trump announced during his time in office in 2016-2020.

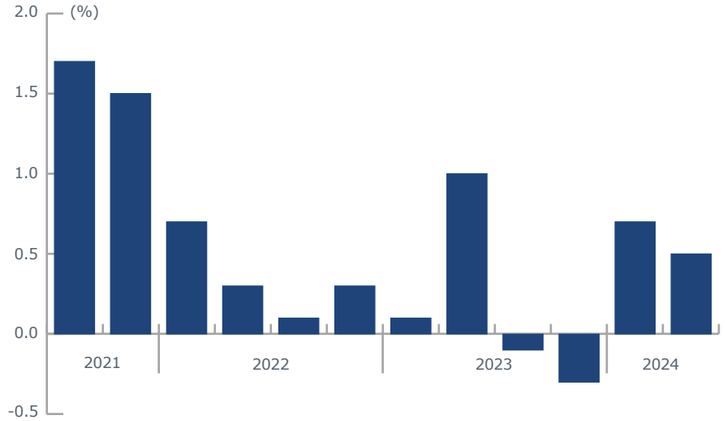


Figure 1:
Quarterly GDP growth in the UK from the ONS

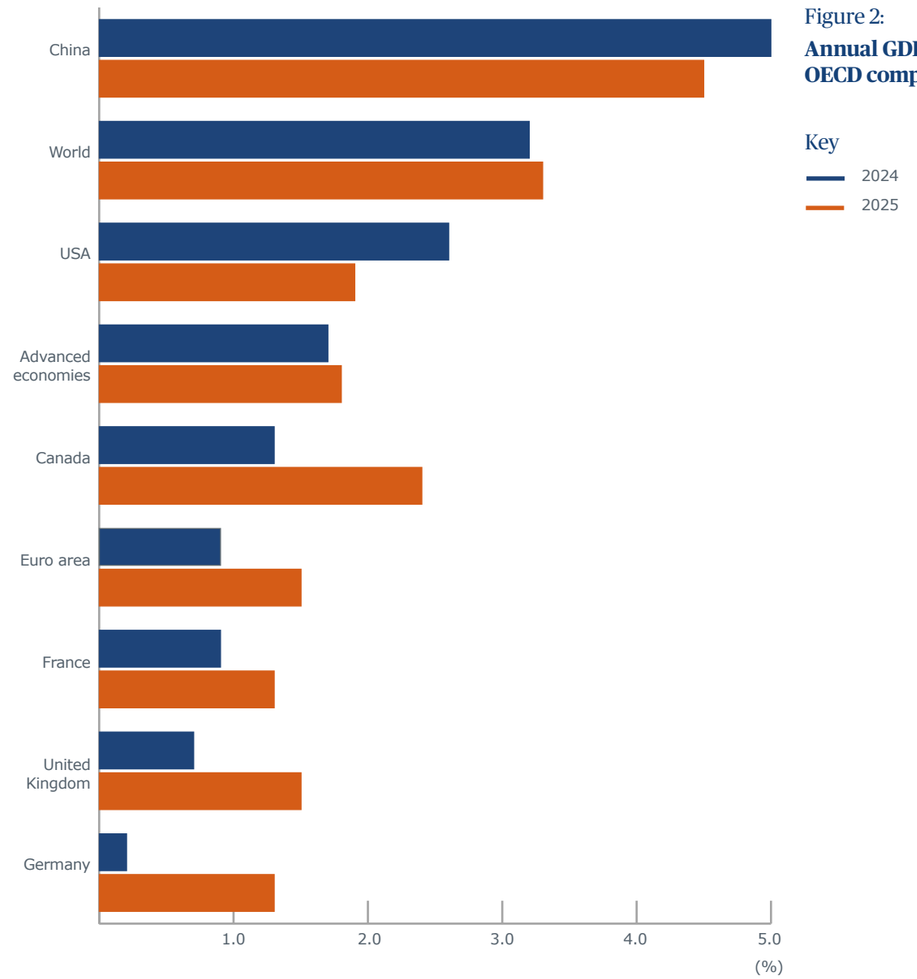


Figure 2:
Annual GDP growth rates across the OECD compared, in 2024 and 2025

Overall economy (cont.)

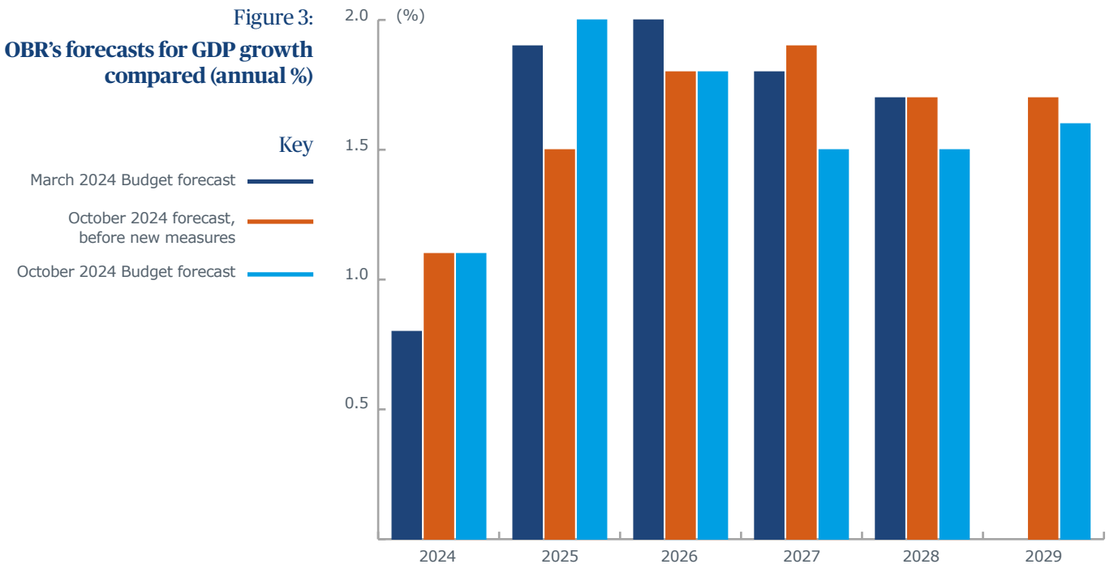
It was hoped that the first Budget under a new, energised government with a mandate for change was going to be a fresh and confident start after years of Budgets punctuated by crises and party reshuffles. Commentators called for a bold plan which delivered on Labour's manifesto pledges to support infrastructure, housing, growth, and sustainability.

Budget and public finances

Over the summer concerns over the health of the UK's public finances prompted large public projects to be paused or have decisions deferred awaiting a detailed Spending Review. This in turn limited prospects for a post-Election bounce as investors waited to see what the new government's economic policy will be.

The Autumn Budget, titled Fixing the Foundations to Deliver Change contained a fair amount of positivity for the construction industry, albeit tempered with announcements such as the increase in employers' contributions to National Insurance levels, which will provide the Treasury almost £24 billion a year in total. Clearer certainty will be given to the industry through the Phase Two of the Spending Review, which will conclude in Spring 2025.

Figure 3:
OBR's forecasts for GDP growth compared (annual %)



Autumn Budget 2024:
https://www.gov.uk/government/publications/autumn-budget-2024

Economic outlook

The Office for Budget Responsibility (OBR) commented that the UK's economic backdrop was largely unchanged since its last forecast was produced to support the last Budget in March 2024. Having stagnated last year, GDP is now forecast to grow by just over 1.0 percent in 2024, and 2.0 percent in 2025 (which is especially significant as the OBR's revised forecast shows growth would slow to 1.5 percent next year if the new measures were not in place).

The OBR stated that Budget policies temporarily boost output in the near term (Figure 3) but leave it largely unchanged across five years when compared to the previous Budget, but that there was scope that if public investment is sustained at a higher level, growth could be significantly higher in the 2030s. The Institute for Fiscal Studies agreed, likening the current proposals to a 'short term sugar rush' that may endure in the longer term if the extra investment and planning reform create stability. Details of how the government spends the money beyond an initial period of front loading should be contained in the Spending Review and later Budgets.

The OBR expects the Bank Rate to fall to 3.5 percent at the end of the five-year forecast. This is approximately 0.5 percent higher than at the time of the March forecast, as public spending and the higher cost of employment puts upward pressure on CPI.

Construction spending

The Budget committed (or reconfirmed) funding for a number of construction projects. The list covered a boost for the School Rebuilding Programme, more funding for housing, tunnelling to Euston for HS2 (although the station is still expected to be privately financed), and a plethora of roads across the country. The New Hospitals Programme will continue on 'a more sustainable and deliverable footing' and 'move swiftly to rebuild hospitals wholly or primarily built with RAAC or which are in build', others will be reviewed and steps set out in due course.

Energy and natural resources were high on the agenda and significant backing was noted for green hydrogen projects, a continuation of support for Sizewell C, and Carbon Capture, Usage and Storage.

In the lead up to the Budget, the government used its powers to take decision-making responsibility for a number of projects which do not qualify for 'Nationally Significant Infrastructure Projects' such as solar sites, data centres, and film studios.

The delivery of these projects will be driven by a newly established National Infrastructure and Service Transformation Authority (NISTA), which will be operational by spring 2025. A new Office for Value for Money will oversee budgets and advise the Chancellor and Chief Secretary to the Treasury on decisions.

However, much of the detail needed for the construction industry should be released in next year's 10-year infrastructure strategy and Phase Two of the Spending Review, as well as the response to the National Planning Policy Framework Consultation which is expected later this year.

Skills

To deliver the projects outlined in the Budget, construction needs a skilled and appropriately sized workforce. Sizewell C alone expects to employ around 7,900 people during peak construction. The newly-formed Skills England was mentioned in the King's speech as a vital interface between 'businesses, providers, unions, mayoral combined authorities, and national government to ensure we have the highly trained workforce that England needs', and it was further mentioned in the Budget.

The Budget set aside £300m for further education to 'ensure young people are developing the skills they need', but with large critical infrastructure, housebuilding, and sustainable retrofit expected to be at the heart of the drivers of growth, we need to ensure that construction can access the labour force it needs.

This was further emphasised by the Construction Products Association's latest forecast, which was issued a day before the Budget, containing warnings of an impending age demographic crisis for the UK's construction skills shortage. At least 500,000 workers are set to leave the workforce within the next 15 years due to a spike in employment of people between 50 to 64 years old, equivalent to a quarter of the workforce. The problem is compounded by the loss of EU workers who were generally younger.

The construction market

Construction output

Total construction output in the UK fell 1.6 percent in the year to July, with falls in both new work and repair and maintenance. Five of the nine main new work sectors saw lower output levels, with the largest fall seen in private commercial whilst private industrial output grew.

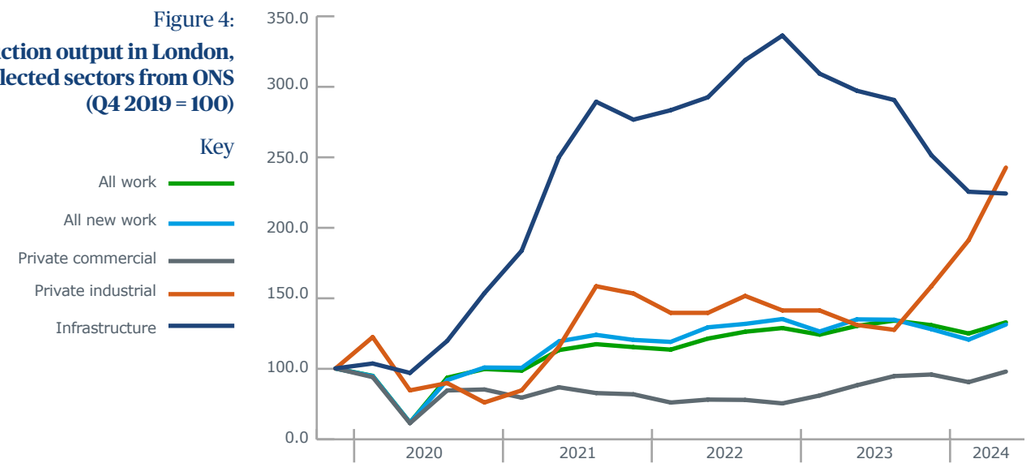
The London construction sector differs from that of the rest of the UK. Its position as a major hub for business means that the commercial sector accounts for almost a quarter of total output in London, nearly double that of the UK total. London relies less on repair and maintenance work as new work accounts for almost three-quarters of output, whereas nationally, it's about half. Construction output in London has been steadily increasing since the pandemic (Figure 4).

All but two sectors of new work experienced growth in the past year. Infrastructure output declined by 25.0 percent and is no longer the main driver of output, but it remains significantly high compared to recent years. Growth is now being driven by private industrial and commercial work.

Changing priorities

The age of the data centre and demand for last-mile warehousing has grown London's private industrial output by 86.0 percent in the last year. Whilst it is a smaller segment of work than the commercial or residential sectors (which between them generally account for 80.0 percent of new orders in London), it is a rapidly growing one and an attractive one for the supply chain at a time when commercial output has been static and lower than pre-pandemic levels. Contractors pivoting away from the commercial sector has been well-documented.

Figure 4:
Construction output in London, selected sectors from ONS (Q4 2019 = 100)



Sentiment on the up

The Construction Products Association's summer forecast anticipated a 2.9 percent decline in UK construction output in 2024, followed by a recovery of 2.0 percent next year. This follows a series of downgrades to their outlook, which coincided with weakening economic sentiment, increased mortgage rates, political uncertainty, the Building Safety Act, and volatile prices.

S&P's Construction Purchasing Managers Index (PMI) suggested a similar sentiment. A reading above 50.0 indicates growing workloads, anything lower marks a contraction. The index fell in the middle of 2023, suggesting contraction as inflation and uncertainty hindered work.

However, for the last six months, the survey has returned a figure of more than 50.0, reaching a 29-month high of 57.2 in September. Allowing for a lag between sentiment and activity suggests an increase in work is on the horizon.

Demand for work

Confidence within the residential and commercial markets will determine growth within the London construction market. According to the ONS, at a national level, the commercial sector mainly consists of offices and entertainment, accounting for 45.0 percent and 20.0 percent of the overall sector, respectively.

Post-pandemic changes in working practices and a need to enhance the environmental features of existing office stock have driven tenant demand in recent years and led to a strong demand for refurbishment. It has also created a two-tier system for rental values, with higher growth for high-quality modern spaces. Take-up for office space in Central London has been subdued, with the largest transactions being for new or pre-let space, suggesting ongoing demand for new quality space. This preference away from second-hand space has left availability levels above the ten-year average for the capital, ending Q2 at 8.3 percent, a slight reduction compared to the end of Q1.

House building activity has been in the doldrums since inflation overtook house price growth. It was further affected by the Building Safety Act, which redesignated residential buildings over 18 metres tall as 'high risk,' giving many a reason to pause and consider the new implications of the Act. Since then, it has been buoyed by supportive announcements on housebuilding and planning reform from the new government. Yet, this positive sentiment will take some time to filter into real projects, as the recent downward cycle has deferred the purchase of sites.

Recent cost inflation and the increased cost of borrowing have placed the viability of projects under growing pressure, and during the peak period of volatility, some schemes were placed under review. A number of these schemes are now being revisited, and teams need to ensure that they are given a thorough review rather than merely indexed to the current day.

Data centres are the outlier. They are a comparatively small portion of London's construction work, but their ability to consume material supplies and labour, particularly amongst the MEP market, is potent. Large data centres can necessitate a workforce size which would rival that of a London tower. Therefore, it is important to acknowledge the growth in this sector, as detailed in the Turner & Townsend Data Centre Cost Index 2024.

Turner & Townsend Data Centre Cost Index 2024:
https://www.turnerandtownsend.com/insights/data-centre-cost-index-2024/

Value for money and the cost of work

In addition to changes in the type of work, the value drivers for output have changed. Funding models in need of credit have struggled when faced with rising interest rates, whilst those backed by shareholders have sometimes struggled to articulate a true value position, especially considering the recent rapid cost escalation.

Material price pressures

The latest report from the Construction Leadership Council's Material Supply Chain Group (formerly the Product Availability Group) sums up the current market, saying that there has been 'little change' in the availability of materials since the summer, and there is generally good availability across the board.

Price pressures have eased considerably, and using the Department for Business and Trade's Building Materials and Components tracker, material prices have generally been flat (Figure 4), showing an increase of just 0.2 percent. Unlike in recent months, fewer materials saw large price swings (in either direction) as the economy was generally less volatile.

In a similar way that steel has been the hot topic of the last few years, this year's volatility has been driven by copper. Often termed 'Doctor Copper' for its ability to predict the health of the global economy, the red metal is vitally important to transmission lines, wiring, vehicles and manufacturing. A raft of supportive measures for the Chinese economy pushed the cost of copper (Figure 5) past $10,000/tonne in the middle of the year, a rally which has been unwinding after the stimulus failed to deliver true growth. This volatility in pricing has become embedded in construction component pricing.

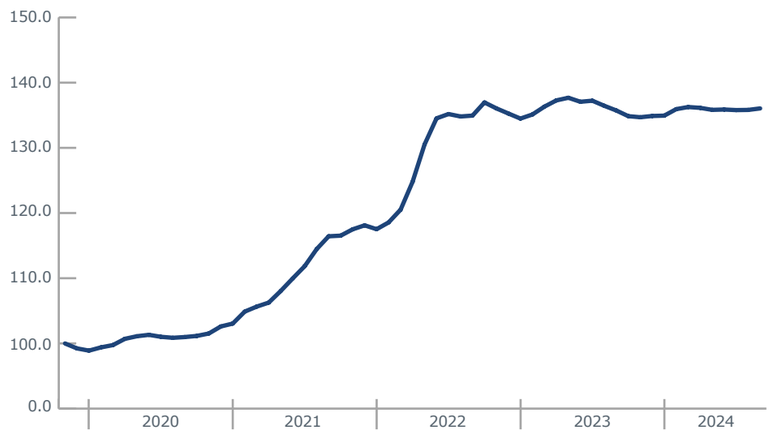


Figure 5:
Indexed material prices, from Department for Business and Trade

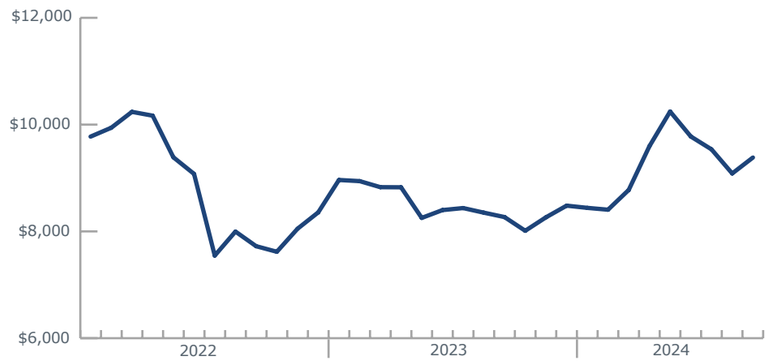


Figure 6:
Monthly copper prices US$/tonne, from London Metal Exchange

Value for money and the cost of work (cont.)

Labour

To deliver the growth expected in construction output, the workforce needs to increase. The Construction Industry Training Board (CITB) reports that the sectors with the highest demand for labour are private housing (supporting the government's objective to deliver 1.5 million homes), infrastructure (to deliver the £700-£775 billion infrastructure pipeline) and repair and maintenance (net zero transition: decarbonisation of the energy network and retrofitting).

Yet, construction employment has fallen by 5.0 percent since June 2023, leaving it 12.0 percent smaller than pre-COVID levels. It could be further impacted, as a lack of confidence has encouraged firms to defer hiring more people until the economic picture (and new political scene) are better understood.

This squeeze has pushed construction wages up by 5.5 percent in the last year in London, higher than the national average increase of 1.6 percent, according to Hudson Contract (Figure 6). Construction wage awards in 2024 ranged from 1.5 percent to 11.3 percent, averaging 5.8 percent. Steelworkers saw the largest increase at 11.3 percent, with a further 5.5 percent next year.

Our last report raised concerns that an increase in workload will compound these labour pressures, and we still believe this to be true despite the rebound in work being a little later. This shortage of labour will drive tender price inflation as demand outpaces supply.

Appetite

Even though capacity still prevails, contractors are being more selective. Appetite in London's main contracting market is variable, which is driven by the scale of work in non-core London sectors and the draw of this, supply chain resilience/stress, plus greater due diligence on the terms of business they are prepared to underwrite and with whom. Projects from trusted or repeat business clients, which appropriately assign risk and are tendered on good design information, are generally well received by the market, whilst projects that do not fill those criteria may struggle to achieve an acceptable list of tenderers.

Financial challenges

Volatility may have calmed, but it has left significant legacy issues in company bank accounts, as demonstrated by the high levels of company insolvencies in construction (Figure 7). The fragility of the contracting market and supply chain has been acutely felt over the last 18 months with the high-profile collapses of Henry Construction (June 2023), Buckingham Group (September 2023), MJ Lonsdale (October 2023), and ISG (September 2024). The full extent of these administrations will take some time to uncover – for example, the administrators for the Buckingham Group only revealed in October 2024 that it owed £300m to its supply chain.

This succession of substantial company collapses suggests that lessons have still not been learned over contracts with an adversarial approach to margins which push risk down the supply chain.

These administrations have affected the bond market, with the reported cost of Henry Construction's bonds totalling £160m. However, the market is learning and becoming more protective (possibly at the detriment to the industry, as covered later in this paper). It is reported that the bond market's exposure to ISG was contained at £60m, a significant reduction to the £140m exposure a couple of years ago.

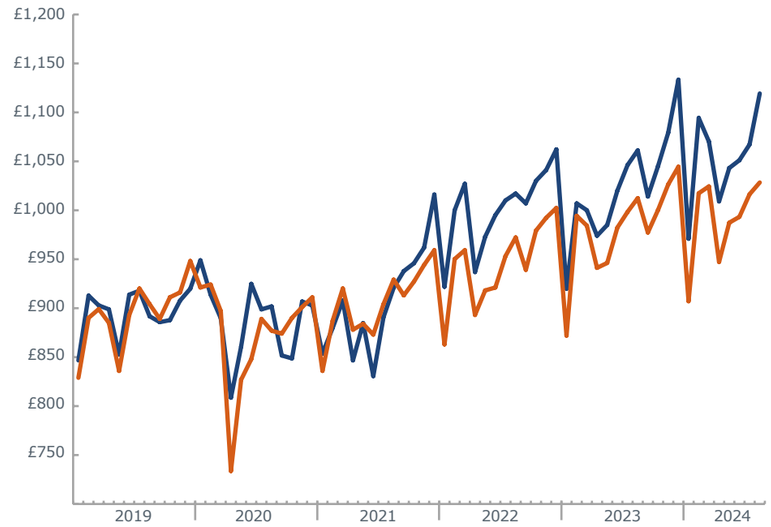


Figure 7:
Weekly construction wages in London and the UK (from Hudson Contract)

Figure 8:
Monthly construction insolvency figures (from The Insolvency Service)

Beyond inflation

What else is keeping costs high?

Recent inflation has led many to consider the cost of construction as 'too high', especially when considered relative to development values. Yet in recent years, prices have been driven by an acceleration of material price inflation, following the squeeze on supply chains (largely as a consequence of the war in Ukraine). Current tender prices, when plotted against a 2000 baseline, have increased by an average of 2.8 percent p.a, which is also the long-term average (Figure 8).

However, the cost of construction has also been driven by non-inflationary factors such as regulatory and specification changes. When combined, these have been significant.

Our analysis suggests that aside from inflation, costs have increased by 8.0 percent to 16.0 percent for offices and 7.0 percent to 17.0 percent for residential since 2018. Without a return on value to offset this level of increase, this has a considerable impact on project viability/affordability.

Reducing costs

Opportunities to reduce construction costs should come from improving output productivity to make the process more efficient - the industry lags behind most other economic sectors – it's a perennial problem. The industry has been slow to embrace digital strategies to improve performance. The adoption of Modern Methods of Construction is often opposed due to the need to lock in supply chain partners early, in advance of a competitive tender process. However, improving how a project team functions and works together will improve productivity. Improvements in productivity will generate faster and more efficient construction programmes with less waste and better outcomes, thereby reducing costs.

The management of risk during procurement and the extent to which it is transferred to the main contractor and down to the supply chain is coming into sharper focus. Risk should be managed fairly and transferred appropriately and equitably - by evaluating the project, using experience, expertise, and knowledge.

The impact of terms and conditions

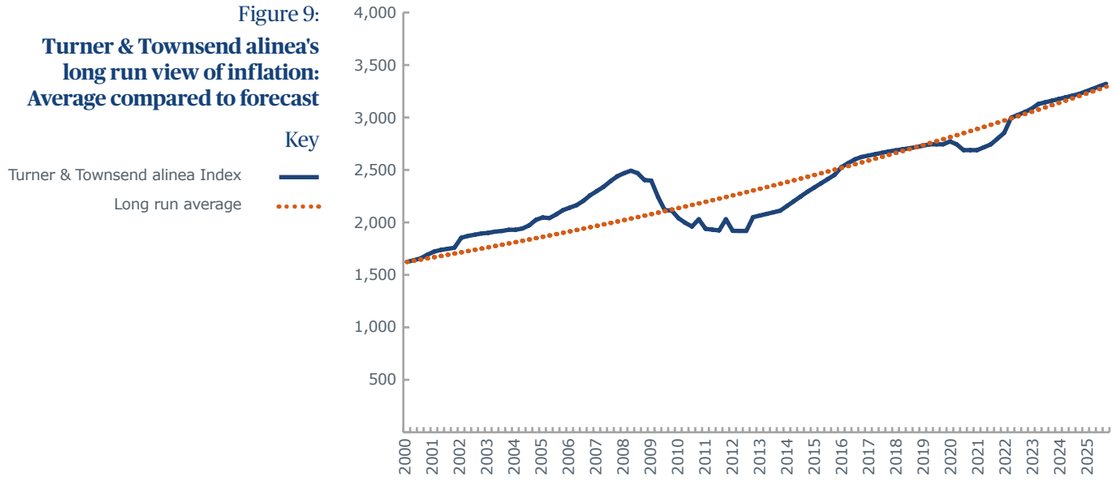
Contract terms and conditions have a direct impact on the cost of construction through increased risk in the construction contract, longer payment dates and defects correction periods. Less cash flowing through a business means additional working capital is required, which is a considerable issue for the supply chain. Performance Bonds are commonplace in construction - in contract theory, they guarantee a contractor's obligations under the contract and protect against insolvency, thus reducing risk for the employer. Most Performance Bond providers are tightening conditions following a string of high-profile construction insolvencies, which can impact trading working capital. This will have a direct impact on construction costs as the cost of doing business increases.

The need to build trust

Construction is an industry full of good intentions. We are still talking about many of the same issues today that were on the table 30 years ago. There are barriers to change and there is no silver bullet. A comment frequently heard within the industry is 'the lack of trust'. This is clearly an inhibitor to change.

The recent and sad news of ISG's insolvency, will shake the industry and shine a light on the delivery model, prompting questions about supply chain fragility and transparency. Calls for a new procurement model are growing louder, but this isn't really the answer. What's required is a better philosophy when it comes to procurement – to build a positive project culture, embrace change, for people to actually do what they say they will, address the points of stress and build trust through the delivery model with a focus on more positive outcomes.

Figure 9:
Turner & Townsend alinea's long run view of inflation: Average compared to forecast



Construction costs

How costs have increased from 2018 to 2024 in response to regulatory and specification change

Offices

+8.0 - 16.0%

Residential

+7.0 - 17.0%

Beyond inflation (cont.)

A clear consensus

There is a clear consensus across the industry - from clients, consultants, and contractors - that the only way to address these historic difficulties is through greater openness and transparency. Trust and Productivity – The Private Sector Playbook seeks to show how. It provides a cradle-to-grave guide, from project concept to aftercare and all points in between, setting out how to deliver better, more smartly, more equitably and more productively. Higher productivity reduces costs, and enables the most effective use of available resources – the heart of sustainable construction.

Many of the measures outlined within the Playbook are high on our agenda. We are bringing consistency to the industry by adopting practices evident within the Playbook, including:

- Build team cohesion from the outset
- Work with clients and project teams to ensure alignment with objectives
- Embed a positive procurement philosophy and drive an equitable risk transfer in contracts
- Promote collaboration and early supply chain engagement to de-risk design and bring increased certainty
- Improve supply chain stress testing and visibility

Trust & Productivity – The Private Sector Playbook is a detailed template prepared by clients, consultants and contractors, seeking to promote a value-driven model of construction, which improves sector productivity.

www.constructionleadershipcouncil.co.uk/wp-content/uploads/2022/11/Productivity-Taskforce_Private-Sector-Construction-Playbook-2022.pdf

Our view for pricing

The Turner & Townsend UK Market Intelligence report (UKMI), published in September, stated that the forecast for tender price inflation for the UK as a whole remained the same as the Q2 report.

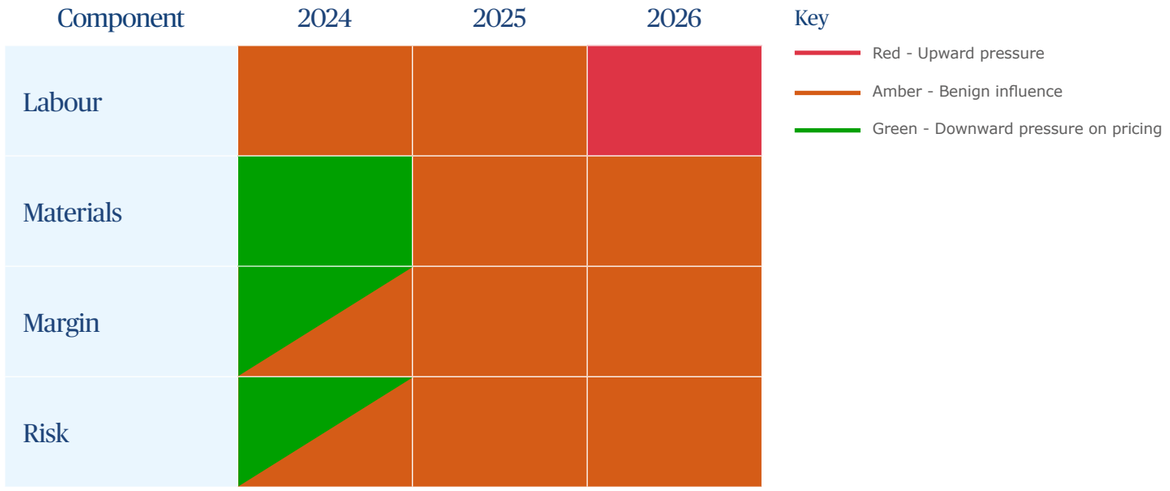
Similarly, we currently see little reason to change our forecast for tender price inflation for London over the coming years. It feels that there has been no material change in the market since our Summer paper, with questions over public finances and higher interest rates enduring. Therefore, we have maintained our forecast for tender price inflation in London during 2024 at 2.0 percent, with an uptick in 2025 to 3.0 percent. There remains the potential for a more marked rebound in pricing when the UK economy improves and encourages renewed investor confidence, whilst constraints in the UK and London supply chains continue.

Overall, material prices have settled, but labour prices have continued to climb as a result of our continued skills shortage and will be a key driver of inflation going forward. Volatility in the wider markets has calmed, but a few years of trials and tribulations have left their mark on a weaker contracting market which is less able or willing to absorb price shocks, and recent high-profile administrations have shown the ramifications of this.

With improving sentiment, we ultimately expect increasing output. How much of this will be publicly or privately driven may be a function of the government's recent budget. How much money the government spends on construction, versus how much the government encourages the rest of the economy.

As confidence increases and translates into pipelines, we expect that shelved London projects may be 'dusted off' and put back out to the market, which is likely to require teams to do more than indexing previous rates to current-day ones. Ensuring specifications/products are fully aligned to the differing market requirements will be key. Similarly, as described earlier, embracing the ethos of the Private Sector Playbook will allow for smarter procurement.

Turner & Townsend UK Market Intelligence report (UKMI):
https://marketintelligence.turnerandtownsend.com/ukmi-q3-2024/



Our view in November 2024 of the components of inflation

	2024	2025	2026
Turner & Townsend alinea	2.0%	3.0%	3.5%
BCIS	2.1%	3.8%	3.6%
Range of selected commentators	1.0% to 3.5%	2.5% to 4.0%	2.75% to 6.0%

Tender Price Inflation forecast for London real estate projects
Turner & Townsend alinea
November 2024

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