Turner & Townsend

UK market intelligence

Building a post-covid future

Spring 2020

making the **difference**

Economic overview

These are extraordinary, unsettling times. Many of us may one day come to divide our lives into 'before', 'during' and 'after' the COVID-19 pandemic.

With most of the UK on lockdown, the construction sector is facing a once-in-a-generation challenge.

Social distancing rules pose an acute challenge to an industry which requires large numbers of people to work together on-site, not to mention the professionals needed to collaborate on the design, planning and pre-construction phase.

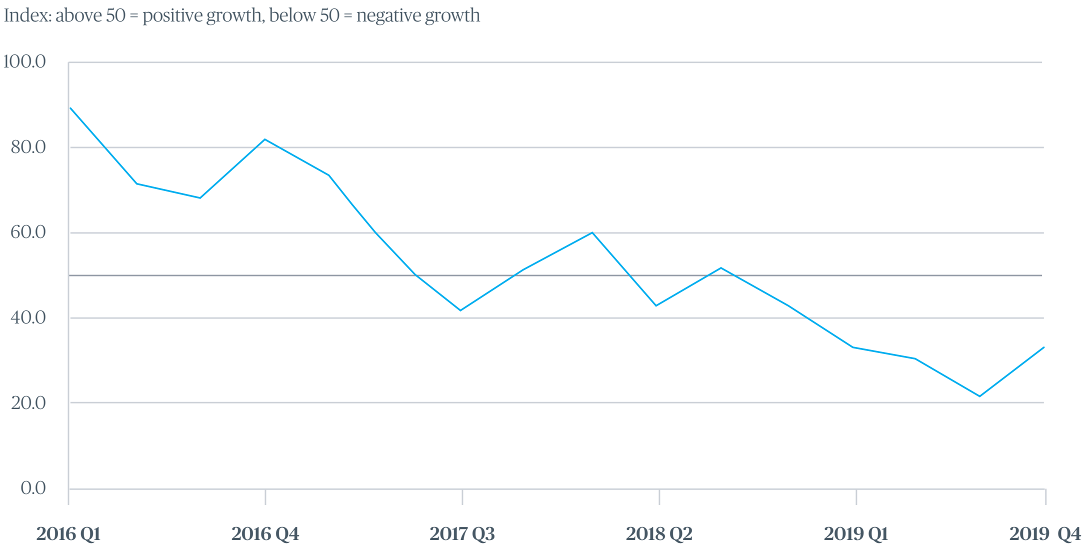
There is one significant bright spot to the current situation. The construction industry went into the Coronavirus crisis from a position of relative strength.

UK GDP growth in the three months prior to the virus's arrival in February 2020 was flat at 0 percent. Construction stood out as the best-performing sector of the economy; construction output during the quarter rose by a robust 1.4 percent compared to the preceding three months.

Turner & Townsend's latest contractor survey also identified an upswing in confidence at the end of 2019. While still negative, it posted a marked improvement during the final three months of the year.

Figure 1:
Turner & Townsend contractor survey: Q4 2019

Is the construction market getting warmer, cooler, or staying the same?



Sentiment was also on the front foot as investor confidence recovered amid the post-election 'Boris bounce'. However the industry's upward momentum was abruptly reversed in March following the rapid spread of COVID-19. The first comprehensive snapshot of the fallout, the March edition of the IHS Markit/CIPS UK Construction PMI survey, recorded the sharpest monthly fall in output for 11 years – with business expectations sliding to their lowest level since October 2008.

Brace for impact

Construction is an industry well-used to riding out downturns in demand. However the COVID-19 pandemic is set to cause one of the sharpest contractions in living memory.

Data from the Asian economies first hit by the pandemic gives a grim flavour of what lies in store for the UK. Singapore's Q1 GDP plunged by 10.6 percent compared to the final quarter of 2019. Meanwhile in China, GDP contracted by 6.8 percent in the first three months of 2020 compared to a year earlier. This is the first quarterly decline since 1992, when official quarterly GDP reports started.

Unprecedented but not uncharted

Our teams working on the ground in these Asian markets have gained an unparalleled insight into the impact the pandemic has on projects, and how best to manage it. Their learnings offer a useful guide to what the UK may now face.

- ☑ Firstly, it is clear that **'in flight' projects are hit hardest.** In China, scene of the original outbreak and some of the firmest lockdown restrictions, projects under construction saw delays of 6-8 weeks – broadly mirroring the length of the country's shutdown.
- ☑ **Communications and collaboration become crucial** when teams are forced to work remotely, and the risk of dislocation is high. Programmes which adopted common working practices and software minimised this risk, with our teams successfully limiting planning phase delays to under three weeks.
- ☑ Clients which showed a **practical and empathetic approach** to their suppliers have also limited delays. Many opted to work collaboratively – even considering partial advance payments to trusted contractors – rather than imposing contractual penalties on the supply chain.
- ☑ Finally, the best run programmes have **used off-site time productively** – reassessing inventory and the financial stability of suppliers – to ensure they get out of the blocks strongly when work restarts. Government support in Singapore and Hong Kong has also sought to limit construction sector casualties during the crisis and smooth the path to recovery.

Here in the UK, the shutdown of construction work has been extensive but not total. With the Government ruling that 'essential' work could continue, programmes in the utilities and transport sectors have remained active, with maintenance a top priority.

The Government is firmly committed to the levelling up agenda within infrastructure, maintaining progress on the initial civil engineering packages on HS2 and bringing forward other investments. Infrastructure has a significant multiplier effect, typically returning a greater economic benefit for every pound spent on capital expenditure. There is an expectation that investment within infrastructure will be used to stimulate economic growth and we anticipate spend to go from 0.8 percent of GDP to over 1.2 percent.

The Chancellor of the Exchequer, Rishi Sunak, has also unveiled – both in the March Budget and subsequently – an array of support measures designed to help British businesses ride out the decline in demand and protect workers' jobs. The speed and scale of the Government's response is unprecedented, with Mr Sunak vowing to do "whatever it takes" to prevent the COVID-19 pandemic doing permanent damage to the economy.

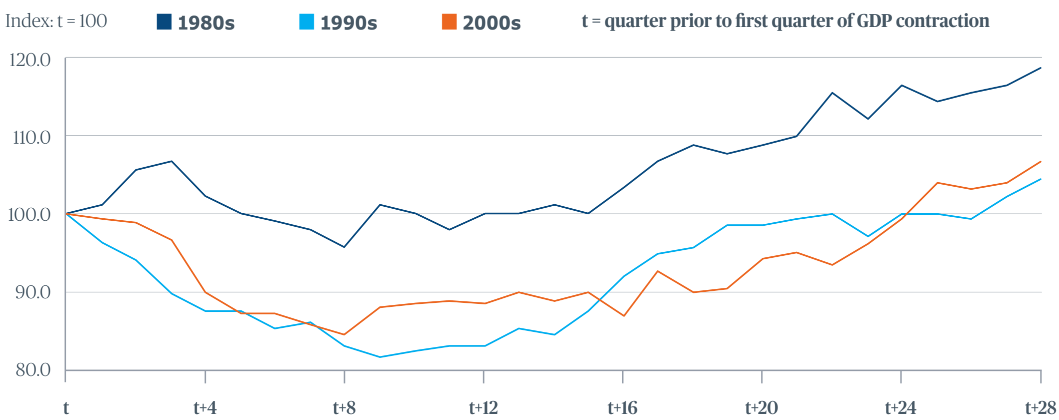
So what is the outlook for industry pricing?

The arrival of the COVID-19 pandemic has now radically changed the inflationary landscape, not least because it has simultaneously impacted both supply and demand.

Early indicators suggest that COVID-19 pushed the UK economy into a contraction in Spring 2020. With the Office for Budget Responsibility (OBR) forecasting that GDP could fall by 35.0 percent in Q2 2020, we may well be in the midst of a technical recession.

Figure 2:
Building cost information service: All-in tender price index

Tender price inflation performance in historical recessions



Recessions normally produce deflation in pricing. From peak to trough, tender price inflation fell by -10.6, -23.2 and -16.7 percent in the 1980s, 1990s and 2000s recessions respectively.

During all three of these previous recessions, tender prices fell by an average of -16.9 percent. In terms of duration, this ranges from just over one year in 1980/81 to 18 months in 1990/91 to hit their trough. To return to the peak seen in the tender price index prior to its fall, it takes around 24 quarters on average – or six years.

However we are in a very different crisis to those that came before.

In 2008 a balance sheet recession occurred. Asset prices collapsed, liabilities remained, and a collective shift towards savings emerged. A credit crunch ensued and demand dried up.

In comparison, the coronavirus crisis has disrupted business activity much more quickly with the economy affectively placed into a straitjacket to contain the virus's spread. Restrictions on peoples ability to move and work have created a supply shock which is also feeding into a reduction in demand.

In the graph below, we have shown the direction of the Turner & Townsend tender price index over the past five years. TPI growth increased at a slower pace following the referendum vote in 2016, partly due to Brexit uncertainty. As of 2019 Q4, our TPI projections were inflationary, supported by prospects of increased Government spending and supply chain imbalances.

Overlaying the 1990s BCIS TPI performance highlights the potential 'deflationary gap' which could occur if the recent OBR forecasts for GDP were to materialise. The 1990s data has been used to indicate the largest reduction in tender pricing as a result of a recession. Here, prices would deflate through to 2022 Q1 before inflating thereafter.

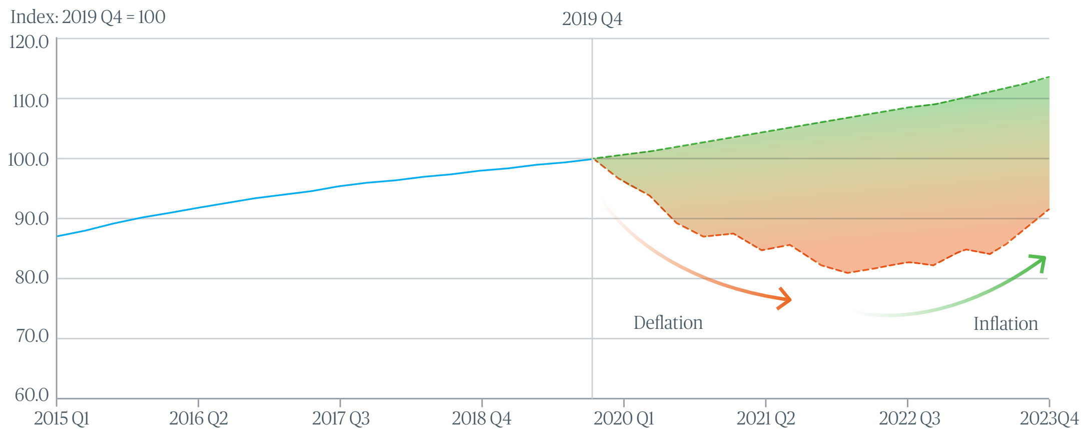
Figure 3:
Turner & Townsend tender price index

2019 Q4 = quarter prior to estimated first quarter of GDP contraction

Turner & Townsend Real Estate TPI

Pre-COVID-19 projections

BCIS TPI performance during 1990s recession



The OBR, however, anticipate a swifter return to GDP growth given the supply led nature of the COVID-19 crisis. Prices may recover quicker under this scenario. Whether this will become a reality and construction could bounce back in the same way remains to be seen.

Ultimately, the depth of recession, length of time in recession and rebound from recession will determine the impact on demand and tender price growth. Below, we look at the complex interplay of factors which may influence the direction of future TPI. Whilst supply disruptions are in place now, it is clear from the data now coming out of Asia that deflationary factors are in the ascendancy.

Deflationary

Reduction in domestic demand

Confidence is likely to diminish as clients wait for the pandemic to pass to ascertain project viability, or understand any structural changes to sector performance and desirability.

As confidence falls and new orders reduce, contractor and supplier pipelines will tend to decrease. The current weakness in demand could see contractors adopt increasingly competitive pricing policies to retain market share and lock in turnover.

Reduction in global demand

Based on data emerging from China and the US, the global economy is likely to already be in recession, reducing global demand and limiting investment.

In Europe, Italy and Spain are among the countries most affected by COVID-19, but also among the weakest members of the EU in terms of economic performance. Increased indebtedness to fight off the virus poses downside risk to financial stability and future growth prospects within the Eurozone.

Realignment of cost base following COVID-19

Most construction firms are now applying salary cuts and overhead reductions. Although largely a temporary measure, falling wages should have a deflationary effect as cost savings are passed through in the form of price reductions.

Fall in oil prices

The price of oil has fallen dramatically, with US crude oil prices turning negative for the first time in history.

Logistics and distribution price pressures are likely to be alleviated with a knock-on effect on plant and machinery operation costs.

Global commodity prices are also declining, applying downwards pressures on materials costs.

Inflationary

Acceleration of insolvencies

Contractor insolvency was a threat even before the crisis. A further surge in insolvencies would thin out the industry's capacity and capability. With fewer contractors to choose from, clients may face a less competitive marketplace and creeping tender price rises in some sectors.

Extended material production shutdowns

Price increases are a risk as domestic supplies and imports of construction materials and components from virus-hit countries are interrupted.

The biggest source of construction material imports to the UK is China, followed in descending order by Germany, Italy, Spain and the Netherlands – all countries which have imposed strict lockdowns on their citizens.

Currency fluctuations and higher import costs as sterling weakens

Market jitters and continued Brexit uncertainty have adversely affected sterling's purchasing power. The weaker Pound is pushing up the cost of material imports.

Productivity constraints as working practices evolve

Output per hour/worker is likely to reduce given the safe working distances and altered working practices imposed to contain COVID-19. Reduced productivity can increase prices as workers become less efficient and firms seek to over compensate for the increased level of resource needed per unit of output.

Risk increases due to uncertainty

Higher risk/uncertainty may lead to tender price inflation as bidding contractors price in unexpected job conditions and the potential for unforeseen interruptions. Open book arrangements should be considered to alleviate unnecessary risk pricing.

Assess, adapt, advance

The International Monetary Fund has dubbed the COVID-19 crisis the 'Great Lockdown' and predicted that it will trigger the worst global recession since the Great Depression almost a century ago.

Just as governments have acted swiftly to curtail social contact and protect public health, clients in the built environment sector must respond decisively to ensure business survival.

All businesses in the sector are now operating in circumstances which they have not planned, but which they must now control.

In this unprecedented environment, it is vital that businesses take action to mitigate the immediate impacts of the complex and fast changing environment, which is beyond routine business continuity considerations. Planning must then turn to securing a level of on-going stability in the face of the evolving situation and then finally to emerge, fit to thrive as disruption decreases and a new way of working and future challenges emerge.

From a capital project or programme perspective, the process can be split into three distinct stages. The initial priority has been for clients to understand and assess the impact of the ongoing lockdown environment on their capital business. Next they must review how they control, and adapt to, their changed situation. Finally they should address any outstanding areas of weakness by implementing a transformation methodology that will prepare the project or programme for the new world.

Assess

Assess overall impact of the environment on current operations and immediate areas of refocus

Adapt

Adapt to the situation, tightly control and optimise core operations

Advance

Advance into more regular operations when restrictions lift

The output is to establish and develop an action driven, risk and opportunity continuity management plan which protects the interests of a client's business and capital project and enables an organisation to be fit and ready to operate in a post crisis, new world.

Below, we consider the key headings which should form a management plan and the key questions client's should seek to address at each stage of the process.

Assess

The objective of the Assess phase is to understand the operating status across the business, take initial action and refocus activity and capability in line with changed priorities to ensure workforce safety and productivity.

Supply chain

The supply chain is the lifeblood of a construction project. It's essential that clients respond to the current environment by showing leadership – engaging with and taking measures to augment the supply chain as the Covid-19 storm rages and in readiness of the lockdown easing.

The interim payment system means construction is more exposed to the deferral of investment than other sectors. Key questions to ask are:

Q. Who are your key suppliers at Tier 1, Tier 2 and Tier 3?

Q. What % are you of their business?

Q. How well do you understand how your project or programme works are scheduled and organised into on-site / off-site labour, plant, base materials, finished goods and technology?

Q. How financially secure are your suppliers? Has forward ordering, prepayment, frequency of interim payments and payment on order been considered to ease potential liquidity concerns?

Q. What data points are available to interrogate - critical path analysis, points of origin, supply chain mapping, category management reviews, workforce planning, working capital assumptions, lead in times, overhead analysis?

Q. How do you ensure your suppliers are fit to come out the other side?

Insolvency warning signs

It is likely the industry will experience a sustained deflationary period in the medium-term, heaping pressure on suppliers and increasing the threat of contractor insolvency in the short term and even as lockdown restrictions have started to ease. Both on-site and logistics suppliers have been hampered by restrictions on movement. This will continue as the lag impacts the post Covid-19 environment.

Clients must be vigilant for any signs of contractor distress. The key questions to ask and actions to consider are:

Q. Are there signs of stress: e.g. inability to deliver prompt responses, lack of record keeping, aggressive valuations?

Q. Is there a practice and consistent regime of detailed checking and interrogation of working capital management information in place to understand liquidity, debts, purchase order receipting, payments flow down?

Q. Can you plug and play other suppliers?

Q. Do you have an insolvency strategy?

Commercial liabilities

Renegotiating contracts for 'in flight' projects may not be practical or desirable. However clients should conduct a contract 'health check', scenario-testing the baseline cost, scope, risk and schedule to give a clear picture of what has been paid for already and what their future commitments and liabilities are.

Contracts still in the negotiation phase should also be reassessed. Where potential liabilities are discovered, these sections should be re-negotiated. Insurance should also be checked to ensure policies are in place to recoup any potential losses.

Adapt

The objective of the Adapt phase is to create a new control capability and understanding of the risk environment, optimising effort and use of resources to ensure activity will deliver results.

Supply chain

Q. Do you understand your sub-supply chain key terms?

Q. How do you carry out your communications and engagement with your Tier 1, Tier 2 and Tier 3 suppliers?

Q. Is your future work schedule visible for each level of the supply chain?

Q. Is a depleted supply chain capable of re-mobilising?

Q. Can the supply chain provide critical resource and/or products as planned?

Construction sites re-opening

As a number of construction sites prepare for re-opening, the new normal will be shaped by radically revised operating procedures on health, safety and welfare grounds. Sites will all have been impacted by travel constraints, off-site manufacturing slippages and reduced global cargo and shipping volumes.

Key issues to consider beyond lockdown into a remobilisation are:

Q. Have the relevant provisions of your contract been invoked prior to re-mobilisation?

Q. Has the all relevant legislation and Government advice been complied with?

Q. What evidence is available to show compliance with guidance on new site operating procedures?

Q. Do the future working practices on site compounds, welfare, workface planning, safety and security and travel arrangements support productivity assumptions?

Q. How are other industries advancing works and planning remobilisation whilst traffic is down?

Q. Has appropriate action been taken to comply with the conditions imposed by insurers?

Commercial liabilities

Q. What flexibility can be applied to shift patterns, workface scheduling, site working hours and welfare and travel planning to reset the schedule and agree revised commercial liabilities going forward?

Q. What is the source and impact of any loss of productivity levels on the critical path?

Q. Are recovery plans accessible which demonstrate how loss of productivity will be alleviated and potentially recovered as lock-down measures are progressively eased?

Q. Is there a commercial strategy in place to address loss and expense exposure and manage claims?

Force majeure

Force majeure - an occurrence which is beyond the control of either party and which neither party could prevent, will be a focal point for both contractors and employers grappling with the contractual impact of the crisis now and going forward.

The key questions to answer when assessing whether this applies to the impact of the lockdown are:

Q. Is the contractor entitled to an extension of time and/or expenses? (entitlements differ under JCT and NEC contracts)

Q. Who is liable for the additional costs of ongoing reduced productivity and extended working?

Q. Can the employer or the contractor terminate the contract?

Q. Have contract provisions been followed to the letter?

Ways of working, enhanced controls and risk management capability

Planning ahead, new controls capability should be considered, allowing control of activity, clarity of performance and building an understanding of the new risk environment. Areas clients should focus on include:

Q. What risk profiles have been developed and scenario tested, which may impact the project and programme strategy?

Q. What is long term Covid-19 position?

Q. How do these risks impact the project and/or programme strategy?

Q. What mitigations have been devised and scenario tested?

Advance

The objective of the Advance phase is to prepare for remobilisation and get productivity back to normal as effectively as possible against the new priorities and ways of operating. The impact areas and key questions should be:

Strategy and performance

Q. Have the new project and programme performance objectives and constraints been communicated and understood?

Q. Are the new priorities formulated into an action plan that can be adopted as you emerge?

Q. What opportunities and synergies are available to promote the transition?

People, labour and supervision

Q. What are the resourcing, skills and learning and development considerations in a new operating approach?

Q. How confident are you that your existing workforce has the capability to adjust to new ways of working to ensure your productivity is maximised?

Q. Is project and activity planning aligned with new ways of working and workscopes?

Ways of working, enhanced controls and risk management capability

Q. Have you identified your new operating model for how you want to operate?

Q. What information is required to reset the project or programme base-line?

Q. What controls and processes are required to govern, aid decision making and ensure effective operation?

Q. What are the value-add tasks and where do they sit in the hierarchy of priorities?

Q. What is the Covid-19 impact on planned transition?

Supply chain

Q. Do you have a capability map that identifies the critical capability you need now, and looks forward to how you emerge?

Q. What about non-critical capability?

Q. What are the opportunities for modern methods of construction and off-site given the longer term impact of social distancing on the design process and site operations?

Q. Have scenarios been worked up jointly with suppliers?

Beyond the bunker

With both the Bank of England and the Government pumping billions into the economy to safeguard businesses of all sizes and millions of workers' jobs, the full might of the state is being deployed to limit the economic fallout of the COVID-19 pandemic.

Nevertheless clients must act quickly and nimbly to mitigate the multiple threats that the crisis poses to real estate and infrastructure programmes.

In most cases, programme strategy – from planning and procurement to risk management and project controls – will need to be overhauled, while front-line tactics will have to adapt and flex in response to unforeseen issues.

The coming weeks and months will require project and programme managers to remain agile; responding promptly to either a tightening or a slackening of the lockdown restrictions. Clients should also keep one eye on the future. The forced lockdown provides an opportunity to get projects 'match fit' for a smooth restart.

Clients should be holding their nerve and preserving the capability that sits within our industry. If they simply transact and look for exploiting cost reduction opportunities it will undermine our supply chain which in the medium term will drive less supply and higher prices.

We are recommending clients work through three distinct phases to ensure their programmes both survive the current crisis and thrive in the post-COVID future.

Assess

Understand the status across the business, understanding the tools and levers to hand and taking initial immediate action.

Refocus against changed priorities, different capabilities and ensuring workforce safety and productivity.

Adapt

Create a new control capability, which supports prioritisation of activity, clarity of performance and understanding of the new risk environment.

Drive efficiency in effort, outcome, in use of resources and ensure there is real world current benefit to activity.

Advance

Be prepared to remobilise when restrictions lift and operations can recommence.

Get productivity back to normal as effectively as possible, re-mobilising against new priorities and ways of operating.

Despite the challenges, there are reasons to be positive about the months that lie ahead. The first is that the recovery, when it comes, could be as dramatic as the downturn.

Unlike a conventional recession, which is typically the product of a complex and interlinked series of events, this slowdown has a single, proximate cause – the immediate, Government-mandated shutdown of the economy. Just as the Government ordered the shuttering of the economy, so too will it reopen in the coming months.

From that moment, growth and sentiment are likely to rebound. Projects and Programmes which can weather the current storm will be best placed to capitalise on the return to normality.

About Turner & Townsend

We are an independent professional services company specialising in programme management, project management, cost and commercial management and advisory across the real estate, infrastructure and natural resources sectors.

With 110 offices in 45 countries, we draw on our extensive global and industry experience to manage risk while maximising value and performance during the construction and operation of our clients' assets.

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