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Construction – sector report United Kingdom

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We expect inflation to continue to fall this year, followed by interest rates from August 2024. Banks will likely reduce mortgage rates accordingly, resulting in a rise in demand for housing in 2025. However, we should remain cautious as many companies are still financially weak. These companies will need to trade out of the red, and in some cases, will overtrade. Delayed projects, a lack of skilled labour, or a shortfall of supply could be the last straw for many. The transition from a low-demand to a growth environment poses a risk of increased trading losses. So, the next 12-18 months will pose the greatest risk during this ongoing financial crisis as companies won't be able to absorb losses.

Sector rating (global): High Risk
Sector rating (United Kingdom): High Risk

Strengths	Weaknesses
High Demand The goal of constructing 300,000 homes remains a priority for both major political parties. Numerous trades within the sector, including Civil Contractors, Roofers, and fit-out companies, stand to gain from these initiatives	**Strained Working Capital** Many companies will need a cash injection to be able to undertake large projects
Skilled Labour The sector has a shortfall of 38,000 skilled workers, which provides opportunities for workers let go from failed companies	**Skilled Labour** Despite the strengths, there will be a vast number of workers who left the sector, either by returning to homes in Europe or by retirement. This leaves a gap in training for skills such as bricklaying, plumbing etc. Companies will need to offer higher wages to compete, adding further pressure to already strained margins
Re-Financing Interest rates are forecasted to fall in the coming months, making it more affordable for firms to obtain refinancing. As we see a return to growth in 2025, pressures on cashflow will inevitably ease	**Invoice Payment Overdues/ Cashflow** There will continue to be an impact from late or none payment. This is affecting the cashflow within the sector, and in many cases has been the reason for failure where firms' finances are already weak

Key trends and challenges that will shape the industry:

1. **Technology and Innovation:** There is a clear move towards a more carbon friendly approach in the sector, with new builds seeing the introduction of pre-fabricated structures. Manufacturing of supplies is at the forefront of innovative solutions to utilise a more sustainable energy source. However, there's a need to retrain workers within new techniques.
2. **Energy:** High priced energy has contributed to many failures in the sector. A move to electric has already been seen in construction vehicles, but sustainable power is very much needed as the sector looks towards hydrogen as an alternative in the future.
3. **Supply Chain:** The cost of materials is stabilising, with many sectors now reporting a fall in prices. This will allow for tender prices to fall, but will initially impact those who have purchased materials at a high price.
4. **Interest Rates:** Rates are expected to fall in August 2024 and are forecasted to hit 3.5% in 2025. This adds to the expected pace of growth from Q2/2025, as mortgage rates become more affordable.
5. **Infrastructure Projects:** The UKs largest project, HS2, had endured many delays and cancellations. The announcement of local infrastructure projects in the north of the country may not take effect until 2026-27, and firms will have to seek additional work to fill this gap.
6. **Cashflow:** The increase in insolvencies through CVLs has provided a clear indicator that there's a shortfall of funds in the sector. Many are holding onto their cash, and paying those who pursue overdues through legal action. This is one of the main drivers for failures, and will take time to level out. So, there's a risk that many firms will resort to overtrading.
7. **Re-financing:** The impact of many years of financial stress has had a material impact to many firms. Those who survived will now show higher levels of debt, reducing their ability to borrow more to support growth. Failure to obtain financing could be the final spade in the ground for many firms.

Construction macro-metrics

Delving into economic indicators like construction output data and insolvency statistics offers a deeper understanding of the sector's performance and vulnerabilities.

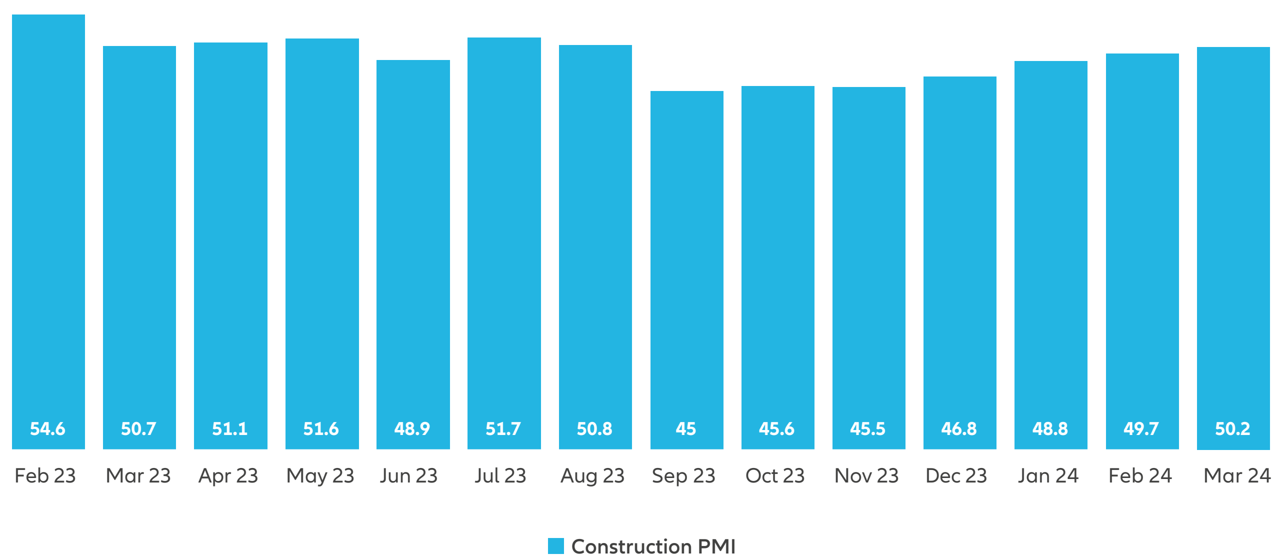
Construction PMI index evolution & macro-metrics

UK Construction PMI rose to 50.2 in March, the highest since August 2023 and only fractionally below the neutral 50.0 threshold. Although only marginal, the rate of new business growth was the fastest since May 2023.

In December, house building remained the weakest performing category of construction work (index at 44.2), followed by commercial construction (index at 49.1) and civil engineering activity (index at 49.8). January data indicated a reduction in total new work for the sixth consecutive month, but the pace of decline was only marginal and the weakest seen over this period.

Average cost burdens across the construction sector increased for the first time since September. Although, there are signs of capacity across the construction supply chain given vendor that delivery times shortened again at the start of 2024.

Figure 1: Construction PMI



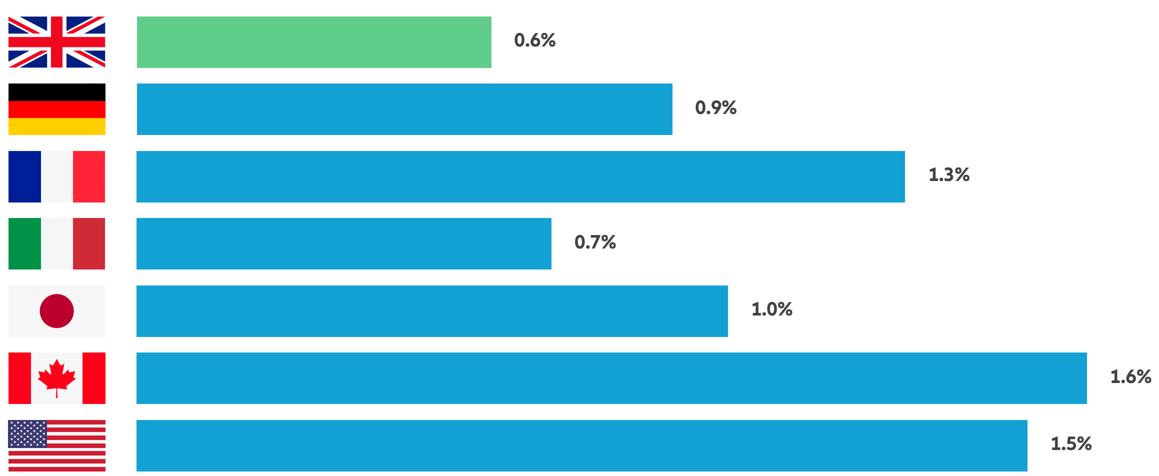
Source: S&P, Allianz Research

2024 is set to be the second year of falling house prices in the UK, with values expected to drop by up to 4% year-on-year. Interest rates held at 5.25% for a third consecutive time in December and borrowing costs remain at their highest level in 15 years. However, the current Bank of England (BoE) rate is expected to be the "pivot rate", with forecasts showing a 100 basis points reduction throughout 2024.

The Consumer Prices Index (CPI) rose by 4.2% in the 12 months to December 2023, up from 3.9% in November and down from the peak of 11.1% in October 2022. However, the core inflation rate (excluding energy, food, alcohol and tobacco) rose by 5.2% in the 12 months to December 2023, up from 5.1% in November 2023.

According to the latest IMF forecasts, the UK is set to have the slowest-growing economy among G7 nations. This is down from a previous forecast of 1%, and weaker than growth of 0.9% and 1.3% expected for Germany and France respectively.

Figure 2: Growth forecast for 2024

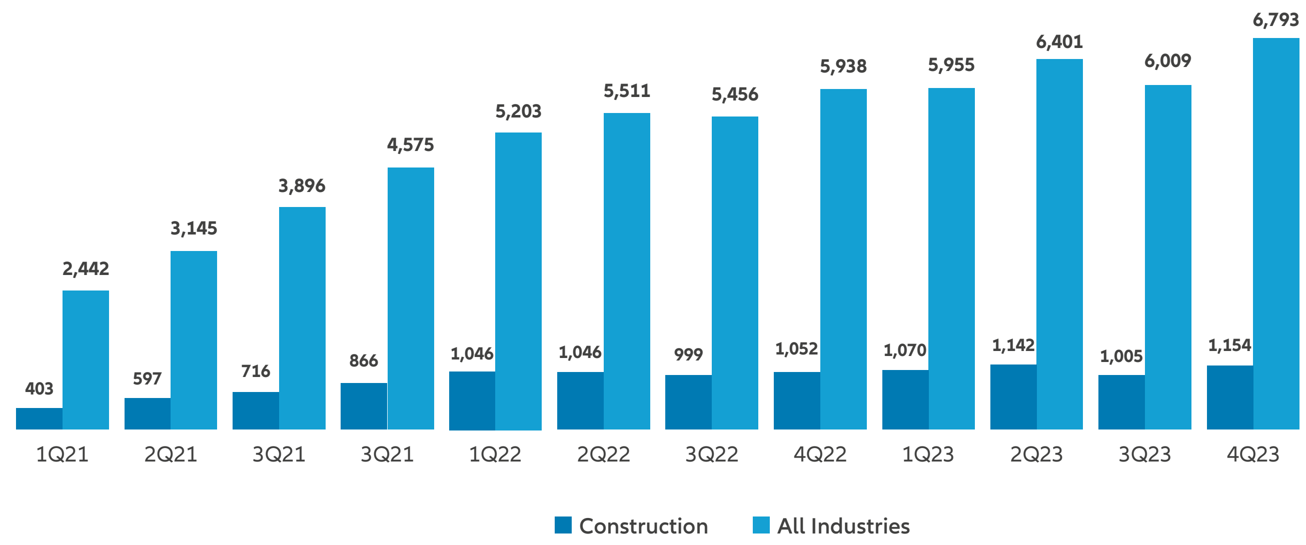


Source: IMF, Allianz Research

UK Insolvencies

According to the last Insolvency Service official statistics, in the fourth quarter of 2023 the total number of insolvencies in the UK remained high with 6,793 businesses failed. This marks a 14.1% increase compared to Q1 2023 but also a +14.4% with respect to Q4 2022. As reported in the previous quarters, construction industry remains the most sensitive sector in the UK economy registering the highest number of insolvencies in the period, accounting for 17.0% of the total.

Figure 3: UK insolvency statistics



Source: ONS, Allianz Research

- Creditors' voluntary liquidations (CVLs) were the most common form of insolvency, accounting for 82% of the total, and small businesses accounted for the majority of these insolvencies.

- The number of registered company insolvencies in February 2024 was 2,102, up 17% compared to February 2023. They consisted of 217 compulsory liquidations, 1,707 CVLs, 166 administrations and 12 CVAs.

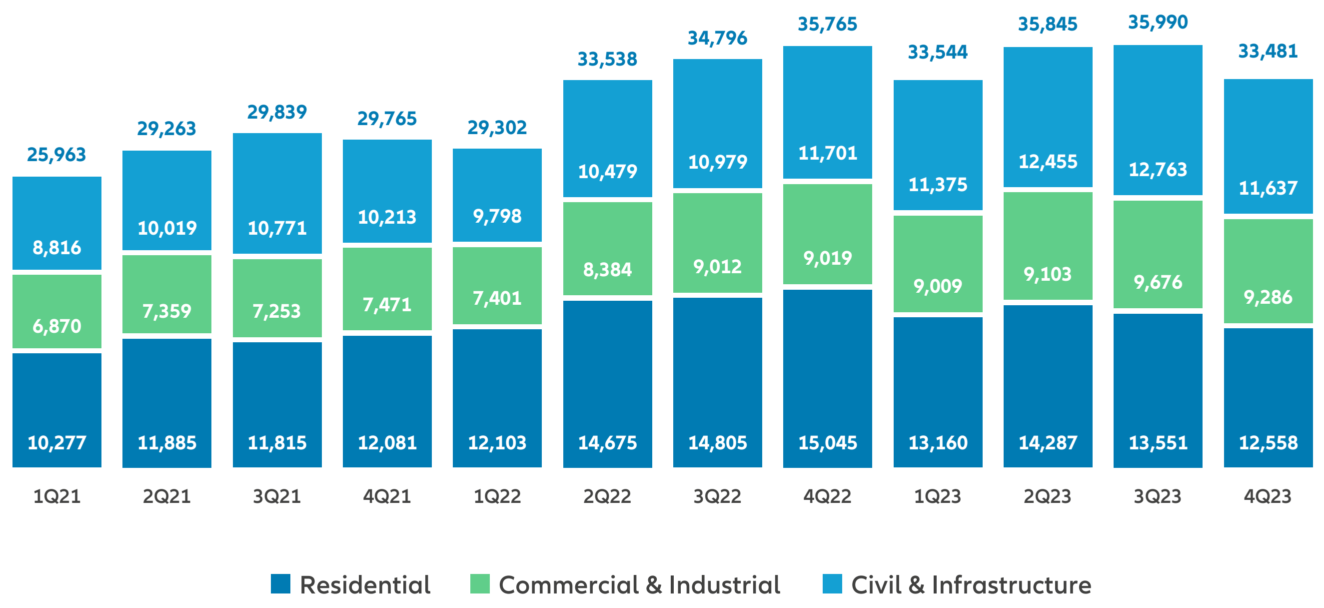
- SMEs and specialist contractors have been the hardest hit, with margins being squeezed by rising costs, increased debt costs due to increased interest rates and project delays. 15% of SMEs in the UK were at risk of facing financing issues in 2023.

- Our Economic Research Department (ERD) continue to revise their forecasts. The latest ERD forecast is for a 10% increase in total insolvencies for UK in 2024 v 2023, and 20% in Ireland.

Construction output data

Aggregate construction output was reported at £33.5bn in Q4 2023, -6.4% vs. Q4 2022. This negative year-on-year trend was mainly due to a drop in new work and depressed infrastructure activity which contributed to falling UK construction output. In the same period, a notable slowdown in housing new orders was also registered as a consequence of the increasing market challenges and high mortgages costs.

Figure 4: Output amount per macro-area (£m)



Source: ONS, Allianz Research

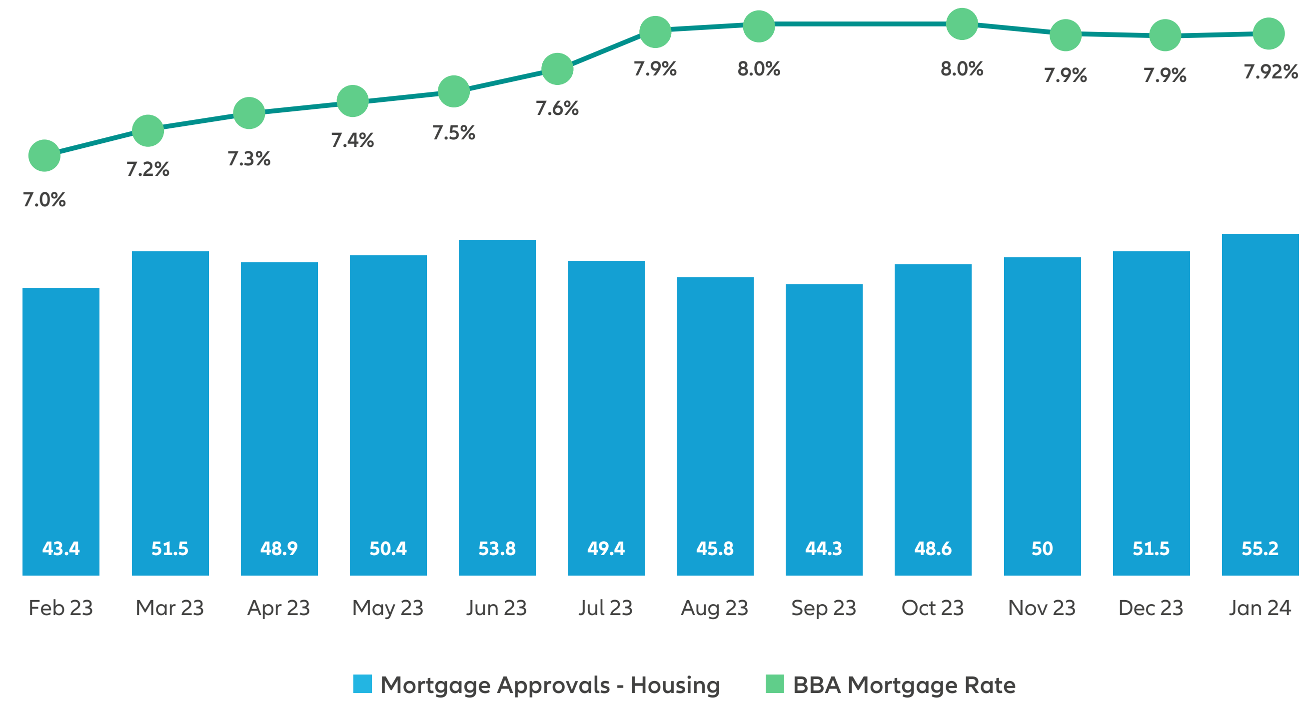
Understanding the nuances within different segments of the construction industry sheds light on specific challenges and opportunities unique to each sector.

Residential

Housebuilding recorded the biggest improvement within the construction sector, with increased new orders. This boost in residential demand is driven by falling inflation and rising consumer confidence. UK house prices rose 0.7% month-on-month in February 2024, with prices increasing up to 1.2% year-over-year. Borrowing costs at the start of the year resulted in an increase in mortgage applications, with approvals increasing by 7% in January 2024 to 55,000.

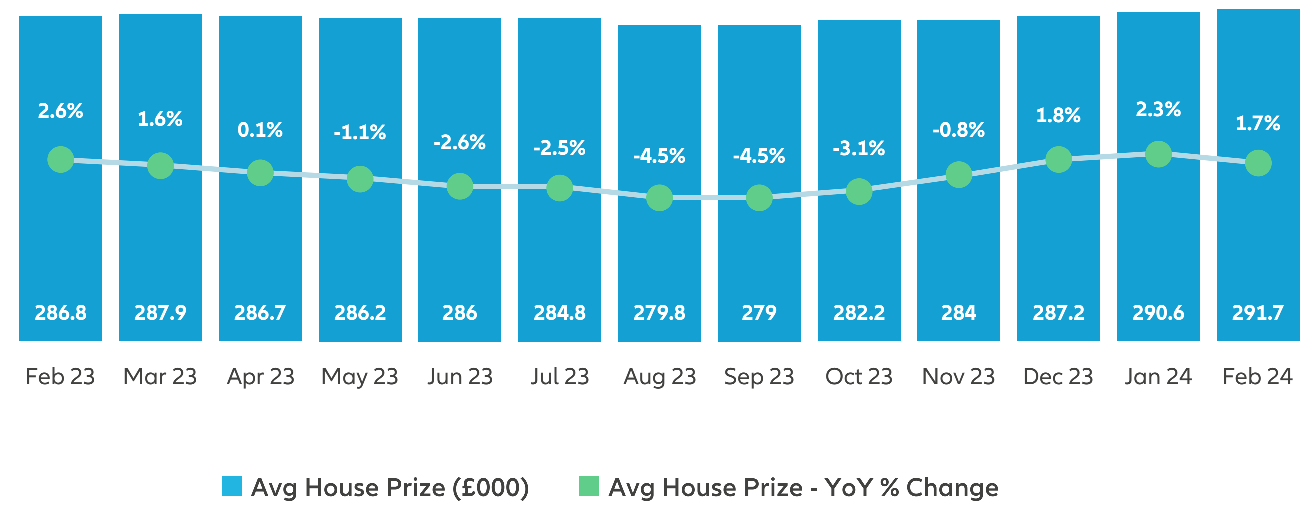
Expectations remain uncertain based on the future path of interest rates, albeit reported expectation is a fall in August 2024. Wage growth was 6.1% in the three months to January, outstripping inflation of 4.2% alleviating household budget constraints. Consumer confidence remains fragile and it will take time for the housebuilding sector to recover. New build projects will take time to move from planning to completion, with forecasts predicting a 2025 return to growth.

Figure 5: Housing mortgages statistics



Source: Halifax, BBA, Allianz Research

Figure 6: Real estate market data



Source: Halifax, Allianz Research

Civil & Infrastructure

The National Infrastructure and Construction Pipeline highlights £164bn in planned investment by 2024/25, including £36bn in investment into Network North. Whilst these investments boost regional employment in roles such as engineering, approximately 60% of these jobs will be in the construction sector. The 660 public and private sector projects aim to grow economic prosperity over the next ten years, with a total investment of £770-£775bn.

Network North confirmed the cancellation of HS2 phase 2a, 2b, and HS2 East in order to redirect investment towards local entities including expanding Northern Powerhouse Rail, resurfacing across England, and mass-transit system in West Yorkshire.

The Institution of Civil Engineers highlight in their 2024 report how the UK is behind on its sustainability goals in relation to the UN's Sustainable Development Goals. It highlights the importance of embracing modern methods of construction such as digital tools to efficiently deliver the design of transport systems, boosting flood resistance through infrastructure investment, and making carbon management a mainstream practice for projects in the entire supply chain.

The UK has had progress towards its Net Zero Targets with it being the first major economy to cut its emission by half since 1990, compared to the EU who have cut emissions by 30%. The UK has announced plans to build new gas-fired power stations as a means to secure the UK's energy security whilst renewable energy generation projects are ongoing.

Commercial

Construction within the retail sector failed to see any major transactions as there was -27% fall in the value of retail work starting on-site against the previous year. This is driven by competition from online retail. According to industry experts, detailed planning approvals grew in the last three months by 27%, totalling £510m.

Canary Wharf Group will receive £118m from a government housing infrastructure fund to support developing a life-sciences centre, a healthcare diagnostic facility and several hundred new homes including 8,000 homes in East London.

Exploring labour market trends and training initiatives reveals the complexities surrounding workforce management and skill development within the industry.

Labour market

The latest ONS study reveals that an average of 38,000 jobs in the construction sector were unfilled in Q1-Q3 2023, a decrease from an average 46,000 vacancies registered in 2022. The total number of employees within the construction sector for Great Britain is registered to be 1.4 million.

Self – Employed Labour

The struggle to find and keep skilled labour is unrelenting within the construction sector. There was an average 674,000 self-employed construction workers in Great Britain in 2022.

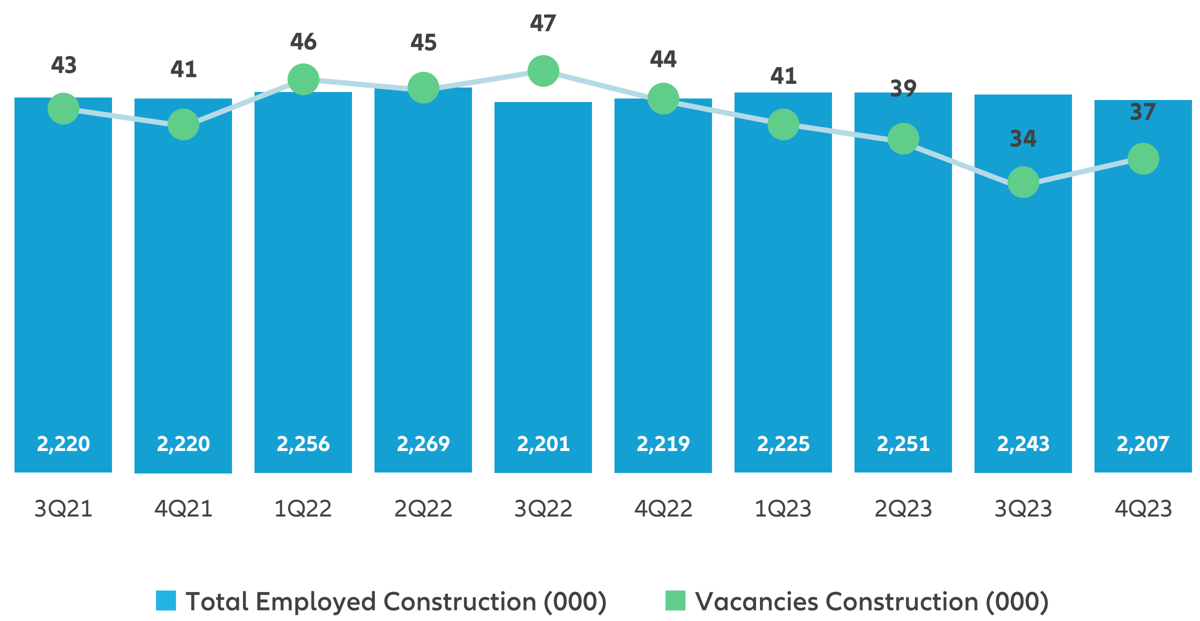
The costs surrounding this continue to grow, as was evidenced in a report by Hudson Contracts – one of Britain's biggest payers of sub-contractors. They reported strong demand for highly skilled self-employed tradespeople, whose pay continued to outperform their employed counterparts.

October 2023 was reported as an all-time high, with average weekly pay above £1,000 in East Midlands, Wales, East of England, London, and South East. Average rates have increased in a slowing market because the most highly skilled people have been retained whilst younger employees have been let go.

General Challenges

Hudson reports more subbies on site as labour rates creep up toward the end of 2023. The new build housing sector has faced some difficulties in rebounding but lower inflation could result in slight improvements in activity. Mechanical and electrical contractors experienced the highest growth in February 2024 at 21%, followed by plumbing contractors at 20.7% and surfacing contractors at 18%.

Figure 7: Labour market trends in the UK construction sector



Source: ONS, Allianz Research

While the construction industry grapples with a myriad of challenges ranging from strained working capital to labour shortages and market uncertainties, there are also significant opportunities for growth, particularly in sectors like residential construction and infrastructure development. By strategically navigating these challenges, leveraging innovative technologies, and addressing workforce dynamics, businesses can position themselves to not only survive but thrive in this evolving landscape. Moreover, partnerships with financial institutions and initiatives aimed at skill development and training will be instrumental in driving long-term resilience and success within the sector.

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Contact us:
If you'd like to find out more on how trade credit insurance can help you, contact us today at +44(0)800 056 5452 or email to info.uk@allianz-trade.com

About Allianz Research
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