PwC Construction and Housebuilding Outlook

H1 2024, January

We are excited to publish the second edition of our PwC Construction & Housebuilding Outlook as we look ahead to 2024. This article provides a quantified view on the UK's spend outlook and a summary of drivers by segment, as well as a comparison to EU performance and a view on the effect of new Climate regulation.

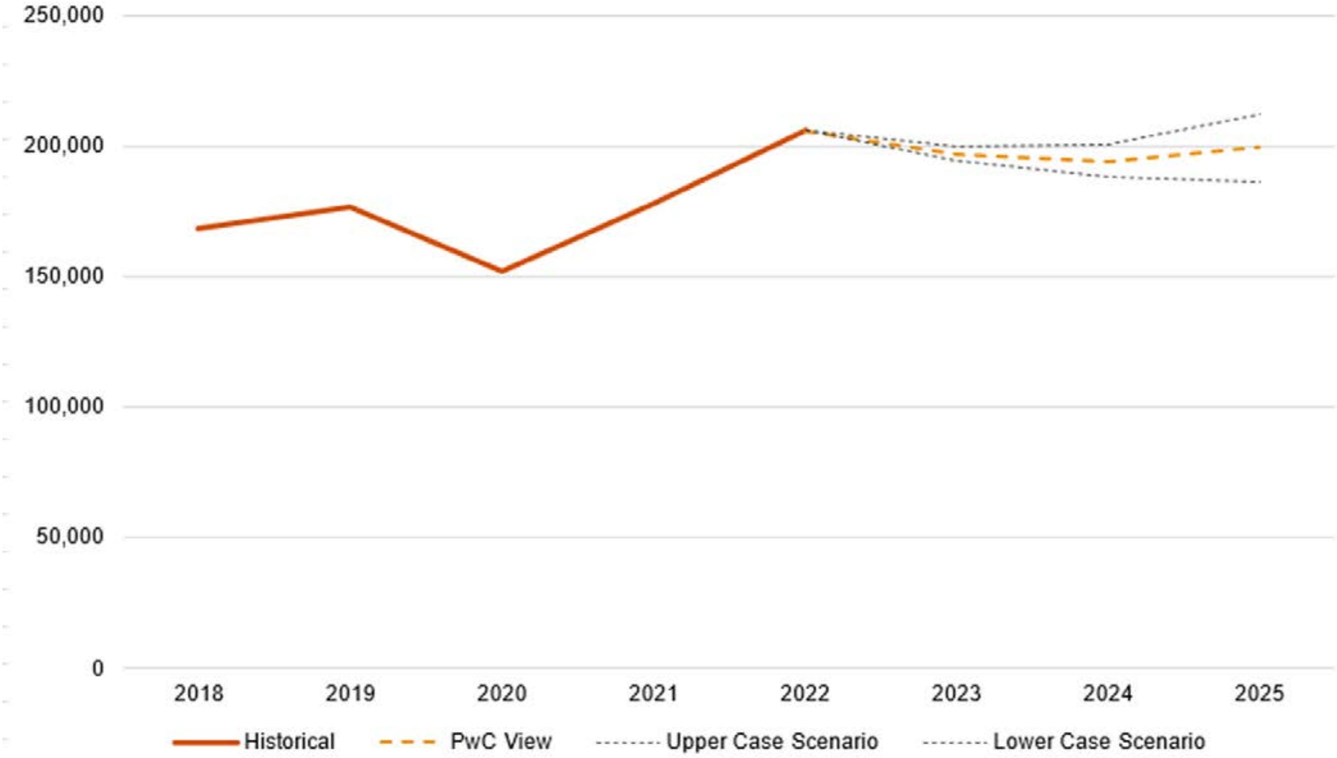
Our forecast is triangulated across publicly available information, 3rd party reports and our regular touch points across the built environment value chain. Note that 2023 figures remain subject to change and that all charts are presented at 2023 constant prices.

Please contact us via **Sam Edwards** if you have any observations or questions. The next iteration of our outlook will be published in H2 2024.

Continued real activity decline expected in 2024, but at a lower rate vs. 2023

UK total construction output forecast

£m, 2018-2025F (2023 constant prices)



	2018-2020	2020-2022	2023	2024	2025
CAGR	-4.9%	16.3%	-4.3%	-1.5%	2.8%

Construction output exceeded pre-pandemic levels in 2022, with 2019-22 representing a period of real growth of 17% even though the industry was facing reduced site access, labour shortages and high energy & material inflation driven by the Russia-Ukraine conflict. During this period, construction prices increased by +8.5%, driving higher profits in some material and product OEMs that were able to pass on cost+ increases, and distributors that benefited from stock value arbitrage.

Subsequent public results in the sector indicate that we have entered a period of price stabilisation/deflation that is impacting financial performance and hampering M&A appetite.

In 2023, we saw a real overall decline in construction spend of -4%, a slight improvement vs. -5% previously expected in June. 2023 performance was particularly impacted by the residential segment which was most affected by high interest rates - see further detail below.

As we move into 2024, the Bank of England does not expect a further interest rate rise beyond 5.25%, but economists also do not expect a substantial downwards shift in the near-term.

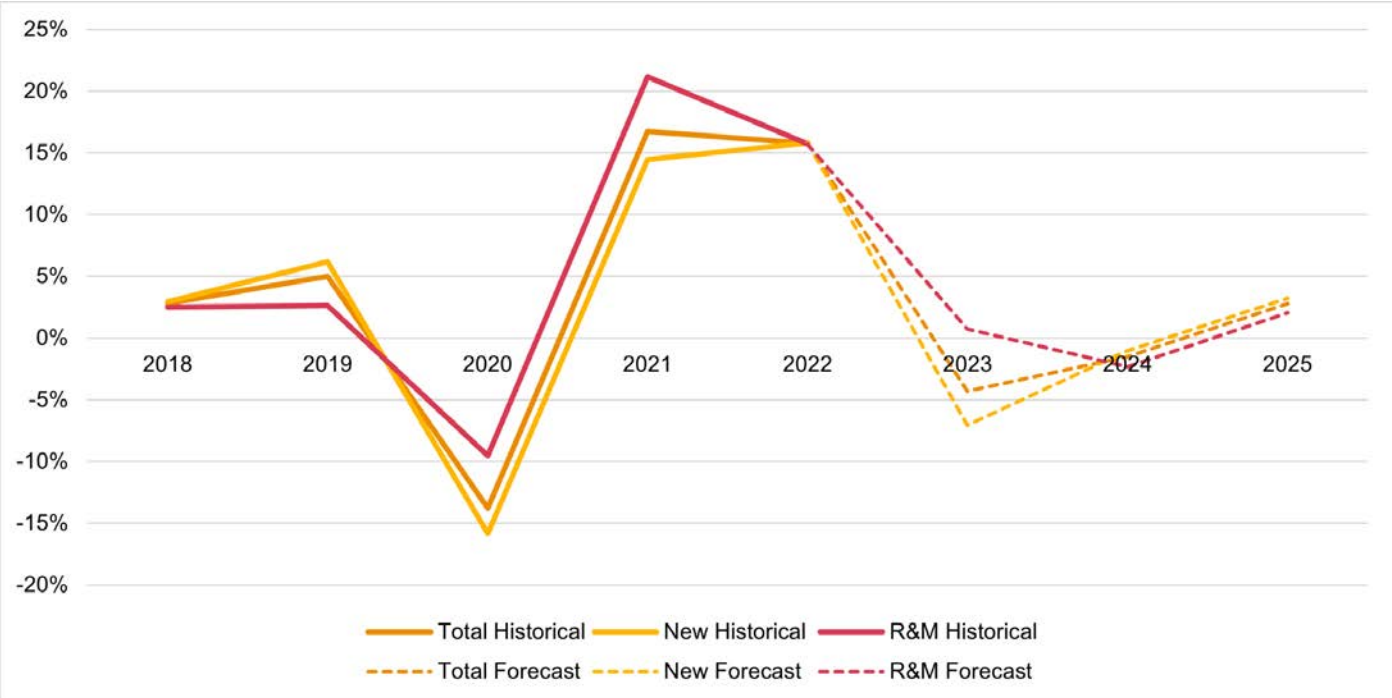
Homeowners are also yet to experience the full impact of rates given the prevalence of fixed term mortgages, and while banks are signalling a potential reduction in headline rates, we are yet to see this realised and the true outlook will depend on macro and geopolitical factors in 2024. In combination, these factors will contribute to a continued challenging demand environment.

Overall, we expect a modest real decline in activity in 2024, offset by a return to growth in 2025, resulting in a broadly flat outlook across the period. This view is subject to change dependent on the fractious geopolitical environment and impact of a potential UK general election that may impact relevant policies - albeit public funding constraints that have led to project delays/cancellations in 2023 (e.g., HS2) are likely to remain regardless of outcome.

Repair & Maintenance output is expected to be more impacted than New Build activity in 2024 as impact on consumer finances increases

UK total construction output forecast by New Build (NB) vs. Repair & Maintenance (R&M)

Annual % growth, 2018-2025F (2023 constant prices)



Repair & Maintenance (R&M) spend has historically proven more resilient to downturns, and this was demonstrated again during COVID. However, the delayed impact of interest rate rises on consumer finances (due to fixed term mortgages) is expected to lead to a greater decline in R&M spend vs. New Build (NB) activity in 2024.

Beyond 2024, all segments are expected to return to growth and the medium-term outlook for RM spend is positive, driven by continued safety remediation post the Grenfell Tower tragedy and retrofit of energy saving measures in residential dwellings (e.g. insulation, heat pumps, solar panels).

Residential output continues to be the most negatively impacted New Build segment, while Infrastructure continues to be most resilient

UK new build construction output by residential vs. non-residential sectors

£bn, 2018-2025F (2023 constant prices)

					Historical Data	S& Outlay Estimate		S& Forecast
Market Segment	2018	2019	2020	2021	2022	2023F	2024F	2025F
Residential	8.30%	9.50%	-20.10%	20.90%	22.9% £m 56,584	-17.50%	-2.60%	5.30%
NR - Commercial	-3.90%	1.50%	-21.20%	-4.50%	7.3% £m 25,473	-2.80%	-0.80%	2.10%
NR - Industrial	14.40%	8.00%	-17.80%	6.10%	56.0% £m 8,111	3.80%	-7.30%	-2.10%
NR - Other	-8.20%	1.50%	-7.20%	1.60%	-1.8% £m 9,927	-2.10%	1.30%	2.50%
Infrastructure	7.00%	8.10%	-3.30%	32.00%	10.7% £m 32,893	3.40%	1.80%	2.70%
Overall New Built	3.00%	6.20%	-15.90%	14.50%	15.80%	-7.00%		3.20%

A -3% decline expected in new build residential output in 2024, following a -17.5% decline in 2023

The Residential sector typically accounts for c.40% of the UK's total construction output and is therefore a key determinant of overall performance. Driven by the negative impact of high interest rates and inflation, Residential construction declined by -17.5% in 2023 and we expect a further decline of -2.5% in 2024.

In addition to macroeconomic factors, the private sector has been impacted by the discontinuation of the Help to Buy scheme, albeit there is speculation on the introduction of a tax incentive for first time buyers in the build up to the general election.

As the path to homeownership is complicated, we expect to see housebuilders continuing to be selective on new starts on sites, focussing on areas where there is greater confidence of realisable demand. We anticipate more will lean into providing alternative tenures such as affordable housing and private rental where partnerships with institutional capital are likely to grow.

The Government established a £4.2bn public housebuilding fund in 2017 and to date only £1.3bn has been spent, with work only begun on one in ten of the promised homes. Project delays have been driven by budget approval gaps given high input cost rises.

Given increased costs the government has reduced its target homes to be delivered via the fund from 340k to 270k. It is important that the government is able to find a way to make sure that investment it has committed to the sector continues to be deployed. This may mean recutting existing arrangements, increasing allocations, and/or diverting investment into higher priority and more shovel ready opportunities.

Overall, the UK remains below its target of adding 300k homes per year, adding 230,000 in 2023. Costs are likely to further increase in due course driven by incoming legislation regarding building emissions which is discussed further in this and associated PwC articles.

Commercial Real Estate is expected to be impacted by high refinancing costs in 2024 and construction outlook remains subdued

Large-scale project starts remain limited as commercial landlords grapple with post-COVID demand uncertainty and increasing cost of capital which has a delayed impact similar to residential homeowners depending on refinancing cycles.

Pockets of activity continue, including Data Centres and Biotech facilities. We also note some uptick in Repair & Maintenance, particularly related to retrofit to improve the quality of office space to promote return of workforce post-COVID.

Industrial activity has been sustained by construction of warehousing following a COVID driven ecommerce step-change which is concluding

COVID drove a step increase in e-commerce penetration, which combined with supply chain challenges that led value chain participants to hold larger stocks, contributed to a high-growth period of warehouse construction. This bow-wave of activity has now worked through the market and expectation is for a reduction in annual build volumes.

Industrial output has also declined, creating a softer demand for manufacturing capacity construction and certain large projects related to electrification have been delayed/curtailed (e.g. British Volt due to lack of funding). Moving forward, further penetration of electric vehicles and their associated infrastructure will drive activity. For example, the planned JLR Battery Plant is estimated to be a £4bn project.

Other non-residential spend (e.g. health, education) returning to growth after a deflated period

Spend on other non-residential buildings has been depressed in recent years but is expected to return to growth over the forecast, driven in particular by requirements in the health, education and custodial sectors. We note that public finance challenges remain and that the Government is seeking cost-efficient solutions, such as the MOJ's approach to the use of standard designs and modular build of prisons to add 20,000 new available places.

Addressing safety concerns related to Reinforced Autoclaved Aerated Concrete (RAAC) in 231 affected schools will also create additional R&M spend.

Infrastructure spend hitting some turbulence but expected to remain strong for the long-term

Infrastructure spend performed robustly in 2023, but was impacted by the curtailment of certain large projects (e.g. HS2's northern link) and slower capital deployment than expected in specific sub-segments, such as Roads and Fibre due to funding challenges.

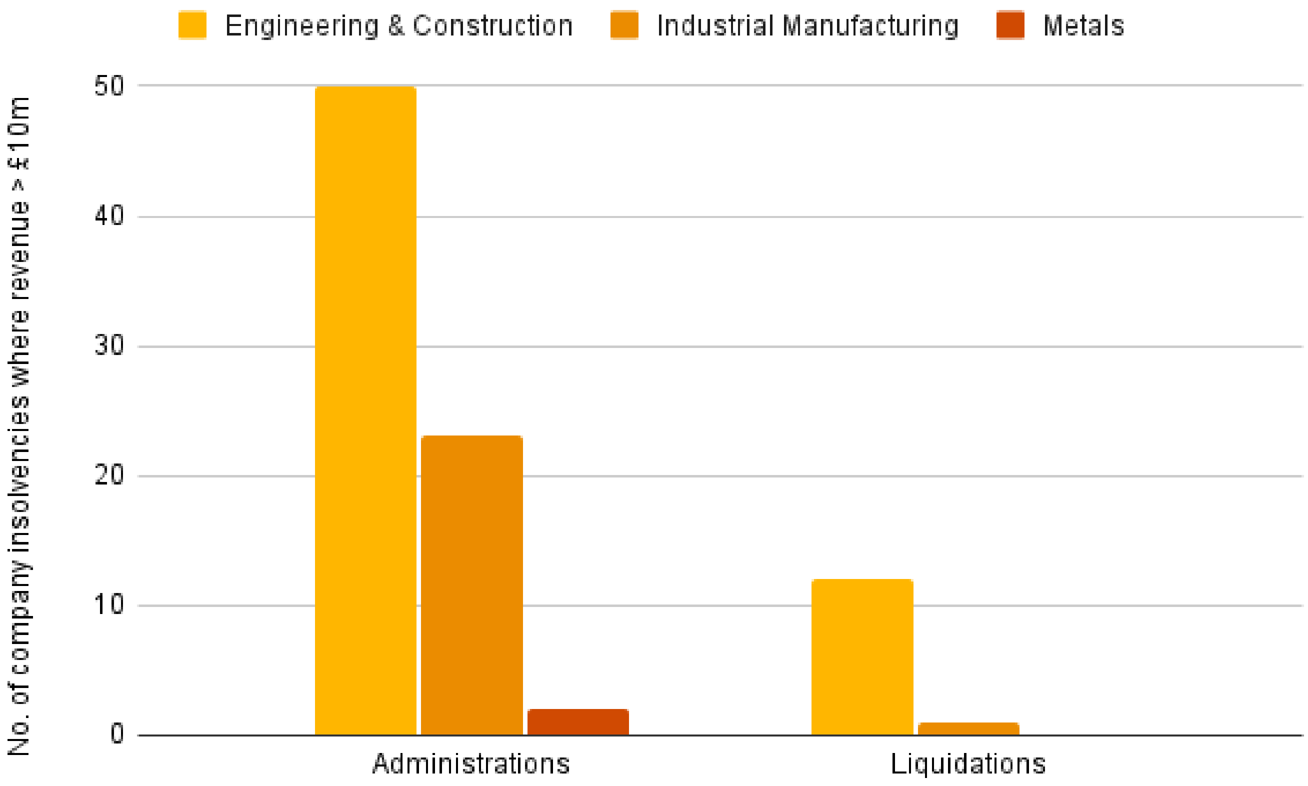
Looking forward, a number of landmark projects are planned, such as the Thames Tideway Tunnel and Hinkley Point C. Which will supplement ongoing spend related to electrification, water and wastewater network improvement and continued roll-out of fibre to the premises.

Overall, the UK's infrastructure spend demand is expected to be one of (if not the) highest in Europe, and we see continued strong appetite from investors to deploy capital in the sector. We also anticipate infrastructure investment to be a key topic of debate in the 2024 general election which could act as a further spend stimulant.

The Industrial Sector faces a high level of Insolvencies affecting the construction market.

Volume of > £10m turnover insolvencies by industrials sector and wind-up approach

#, Jan - Nov 2023



In our last update we noted that there had been an increase in higher profile failures when compared to other industries. The number of failures of mid sized contractors & developers has continued to increase given inflation pressure and reduced new project starts.This trend has now also expanded into the housebuilder sector where demand has slowed impacting access to cash. There is an increasing trend towards a sale of land banks to support cash flow.

However, smaller house builders often do not have access to excess land or deeper pools of capital to help support short term liquidity. Performance bonds on construction contracts are harder/more expensive to obtain as a consequence of the failures of large companies such as Henry Construction Projects Limited and Buckingham Group Limited, where the Sureties have had significant claims. Some of the Sureties at the smaller end of the market are not currently providing cover at all.

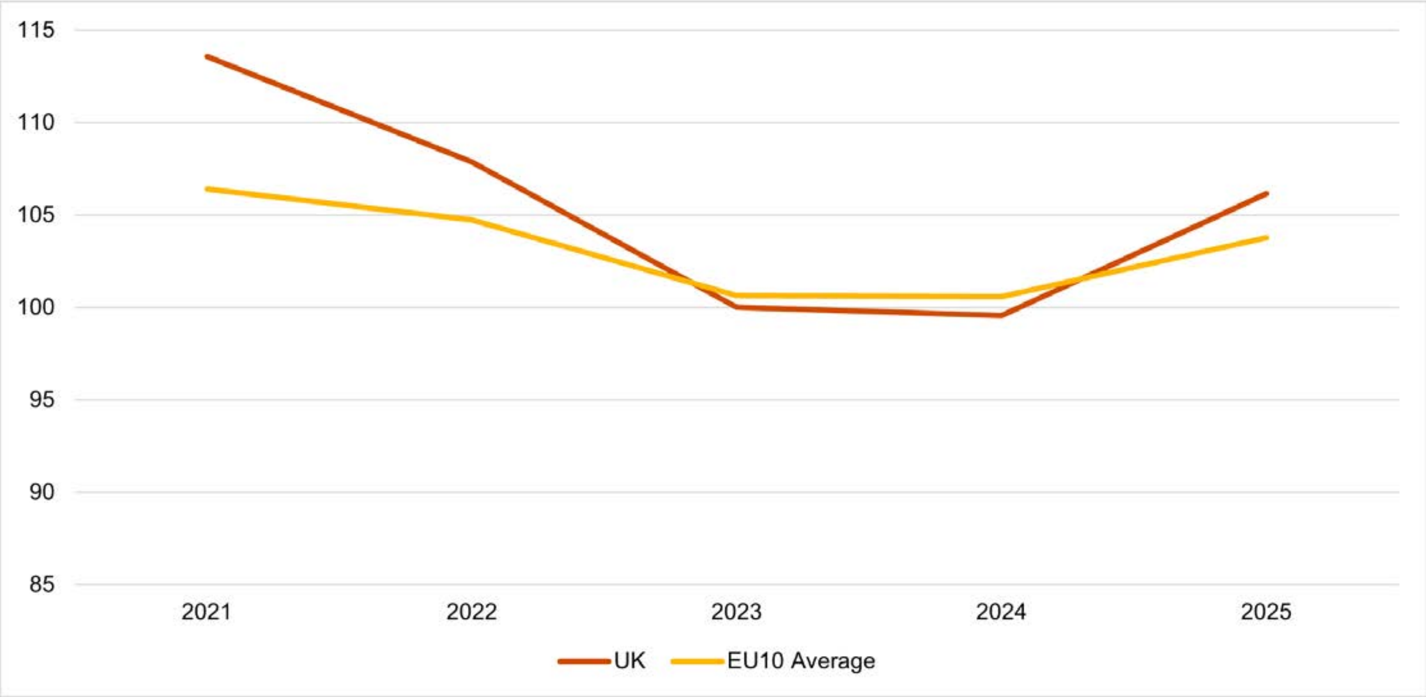
Feedback suggests that contractors are using other means to circumvent this issue, such as reduced payment terms. Our credit risk forums highlight that suppliers into the industry continue to see overdue payments, even when extended terms or payment plans have been granted. There is an increase in overdue debts being reported to credit insurers. Suppliers are linking this in part to the knock on effect of the failure of some of the bigger insolvencies during the year. Suppliers continue to take a tough stance on credit risk, asking for more financial information before granting credit limits, and are less willing to allow payment delays without action, such as putting accounts on stop or requesting pro forma payments until old debts are settled.

The impact of this on the working capital of some businesses could be significant. Main contractors are also finding it harder to obtain credit limits, partly due to price inflation, and are looking to the contractors further down the chain to give them access to credit. As discussed in our last update, we continue to see a trend towards increased diligence on major contractors by developers before entering long term contracts, both when the project is taken on, but also in an ongoing monitoring of the risk and financial resilience of their supply chain.

The UK's construction spend has performed more robustly than its European contemporaries but is expected to be more affected across 2023-2024

UK construction market growth vs. top-10 European country average

2021-2025 (% growth indexed to 2023 UK performance)



The UK experienced higher post-COVID growth in 2021 and 2022 than the average of the top-10 European countries by GDP, which can be attributed to a range of factors, most notably due to its large ongoing infrastructure, industrial and non-residential projects (conversely housebuilding has been more negatively impacted).

In 2023, the UK continued to grapple with rising interest rates and inflation while EU rises stabilised.

At the same time, the UK has been impacted by political instability which is likely to continue for the next 12+ months. In the longer term, the UK's construction spend growth is expected to exceed that of Europe, given its requirement to upgrade ageing infrastructure and as one of few developed economies expected to see medium-term population growth.

Incoming regulations around Climate Change and the Environment are going to impact the sector and need to be sufficiently planned for

Buildings are responsible for 39% of global energy related carbon emissions, 11% from materials & construction and 28% from operational emissions. The path forward for decarbonising construction is clearer for certain material categories (e.g. Steel) than others (e.g. Cement), albeit progress is being made in all areas.

Given its contribution, reducing building operational emissions could have more overall impact and from June 2023 new regulation was adopted by the UK's residential segment that requires housebuilders to reduce new build carbon emissions by 31% through use of insulation and use of electric heating & renewable energy sources. These regulations also dictate that new build properties should include preparatory work for an EV charge point.

Looking ahead, improving circularity is expected to be a key focus for the construction industry, with new legislation expected to be introduced regarding the use of recyclable packaging for building materials. While many regulations, such as the single-use plastic ban or CBAM will first come into effect in the EU, they will have an immediate impact on UK industry due to its reliance on European suppliers and likelihood of adopting similar regimes.

As well as adding cost to projects, introduction of such regulations requires contractors to more accurately measure and demonstrate compliance of their direct (scope 2) and indirect (scope 3) emissions, which in general the industry feels poorly prepared to do.

While presenting an additional challenge alongside growing demand and cost tensions, momentum is gathering pace to decarbonise the construction and buildings that will create opportunity for early adopters and risk for those that are laggard. PwC will release further insight on these topics ahead of our 2024 H2 Construction & Housebuilding outlook.

We believe that greater collaboration between stakeholders in the construction value chain will be key to unlocking its productivity potential and wider targets in e.g. decarbonisation. Our ambition is to help organisations and the wider sector achieve this by facilitating connections and sharing best practice.

Please do not hesitate to get in contact if you would like to join the conversation.

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Thank you

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