WHAT'S THE CORRELATION WITH INFLATION? EVERYTHING!

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Inflation has been the scourge of most UK businesses of late, not least those operating within the construction sector as its impact becomes ever more far-reaching. Operating within an already stretched economy often means that it is even more difficult for building professionals, particularly those in small businesses, to stay competitive or even afloat.

"Inflation is a double-edged sword"

CURRENT CHALLENGES FOR THE SECTOR

Looking forward into 2023 and assessing the current financial landscape in the construction sector is prudent for building professionals so they can know what to expect in the days ahead and to determine where efforts should be focussed to meet the challenges head on.

Statistics from a recent survey undertaken by construction consultant Gleeds, reveal that 77% of contractors in the UK believe that growth in the sector is suffering because of inflation. Inflation in the UK is a by-product of a myriad of factors, including a devalued pound, the increase in energy prices (primarily owing to the Russian invasion of Ukraine) and labour shortages following Brexit. Inflation is a double-edged sword in that it acts cyclically as both the cause and effect of instability within the construction sector. The aforementioned factors in turn led to shortages of materials, volatile and unreliable supply chains and logistical challenges.

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Some construction professionals anticipate that, at best, there will be little to no growth this year, just a levelling-off of profits, whilst others are less optimistic and suspect there will be a deeper recession in the UK. The overall attitude in the sector is, however, fairly positive, perhaps in part thanks to the resilience it exhibited during the recent Covid-19 pandemic, when the industry thrived at a time of economic downturn for many.

CONSTRUCTION AND GDP

The construction sector accounts for 13% of UK GDP, making it a sizeable contributor to the national economy. Whilst the continued demand for housing in the UK suggests some security for the industry going forward, as interest rates rise, the ability to finance projects and secure a healthy bottom line appears increasingly challenging. Additionally, this could lessen the demand for new homes as increased mortgage rates make acquiring a new property prohibitively expensive. Indeed, recent studies by Taylor Wimpey indicate that there are already signs of stunted growth within the housing market. This is likely to continue as individuals readjust their priorities owing to the cost of living crisis. Notwithstanding, reports from the Construction Index suggest that the commercial sector is faring better, with a 5% increase in new orders for private commercial projects since Q4. As of September 2022, the industry work had grown by a promising 4% compared to pre-pandemic levels. The government's recent commitment to spend £600bn on HS2 and other infrastructure projects over the next five years is also encouraging for the sector.

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Ensuring projects make commercial and financial sense will determine the viability and continuation of many UK businesses and maintain investor confidence in UK projects.

GETTING PREPARED

The following are some key tips to prepare for the challenges ahead:

- **appropriate contract forms** – consider including additional provisions giving parties extra breathing room should they need to deviate from previously agreed pricing structures. Both the JCT and NEC suite of building contracts can be appropriately amended. Carefully considering and adapting the contract for the appropriate timeline and associated risks of a project will put parties on a firmer footing;
- **risk assessments** on live projects – employing comprehensive risk assessments may help to mitigate any hiccups throughout the lifecycle of a project and by extension, thwart any disputes before they arise. Feasibility studies that utilise accurate projections of costs should also be used where possible for funding and insurance purposes in order to avoid shortfalls and/or delays;
- **fluctuation provisions** – these are a good way to properly manage the risk of price inflation, as well as ensuring works are reasonably priced from the outset which will allow flexibility to reflect and react to inflation. However, they need to be drafted carefully and appropriately;
- **sourcing materials** – determining a reliable source for materials should be front of mind to ensure that both the costs of and timing for deliverables are met. Having alternative suppliers, both locally and internationally, will be useful as a fall-back contingency plan. Sourcing materials ahead of time may also limit the risk and adverse cost effects of materials should they become unavailable; and
- **increased risk sharing** – strategically spreading the pricing risk of uncertainty further down the supply chain will result in enhanced security for stakeholders further up the chain. This can be achieved by appropriate contract drafting as well as the use of warranties and/or securities (for the wider sharing of contract risks), which will be particularly attractive to main contractors.

PRACTICAL CONSIDERATIONS Q&A

a) Q: Do I have sufficient contractual mechanisms to offer the necessary protection and manage risks?

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A: If unclear as to how these should operate, it is prudent to get advice to make sure they are functioning correctly. Alternatively, if there are no adequate contractual mechanisms, consider whether a collaborative approach is required to agree variations to the contract.

b) Q: Is there any insurance that could cover increased costs?

A: If yes, consider making a claim under the policy, weighing up the pros and cons.

c) Q: If all else fails, does it make sense to terminate?

A: This is typically a 'last resort' option and carries risks when utilised. It is always best to seek legal advice before termination is considered.

LOOKING AHEAD

The government and construction sector will need to work together to ensure that the UK remains attractive to foreign investors and secure confidence in the national market. Adapting to remain competitive in a global investment market is not a choice but a necessity. Having a proper plan and being proactive will put building professionals in good stead to face tough times ahead and remain agile in an already saturated and competitive market. WFW can help reduce these risks and help navigate you through the choppy waters ahead.

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