Insight

Uncharted waters or temporary choppiness? – How to navigate the Brexit storm

By Paul Connolly, Managing Director, UK Cost Management

Whatever the ultimate impact of the UK's withdrawal from the EU, construction clients must first get to grips with a series of more immediate challenges. Here we offer a summary of the main issues for organisations with projects and programmes already in flight – and potential solutions.

The economic and political fallout of the Brexit referendum result was immediate and dramatic.

The Governor of the Bank of England has since described the UK as suffering from "economic post-traumatic stress disorder" and warned that London's overheated commercial property market is now a key risk to the British economy.

The long-term outlook remains highly uncertain, but in the immediate term three things have become clear.

- The process of Brexit will take at least two years.
- Economic uncertainty is likely to continue throughout that time.
- Sterling weakness is driving up the cost of imported materials.

Alarming though this backdrop is, for the UK's construction industry, the post-Brexit climate is in many ways a continuation of what went before.

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But what will the new market reality mean for those who have already embarked on a capital investment programme in the property, infrastructure or natural resources sectors, and how should they make the best of it?

Impact areas and mitigation strategies

Existing capital programmes are likely to be affected in four key ways by the current climate. It's essential that those responsible for them take immediate stock, and assemble both the information and expertise they need to mitigate the impact.

The four impact areas are:

1 Supply chain

The supply chain is the lifeblood of a construction project, and it's essential that clients respond to the current environment by showing leadership – engaging with and reassuring their contractors.

The construction industry supply chain's interim payment system means it is more exposed to any erosion in confidence or deferral of investment than other manufacturing sectors. With contractors usually receiving the bulk of their payment in arrears after work is done, suppliers are often viewed as financing much of project delivery.

That financial pressure, coupled with the systemic skills shortages that have affected much of the construction industry since the global financial crisis, has put increasing strain on supply chain capacity in the past 24 months.

The trend is particularly marked in London, Cambridge and Manchester – three markets identified as hot or overheating in the latest edition of Turner & Townsend's international construction market survey (ICMS).

The ICMS, which is an authoritative study of construction costs in 38 global markets, also found that preliminaries (set-up costs) for a project in London were among the highest in the world.

The fear is that the underlying slowing reported by the ICMS and likely to be exaggerated by Brexit will result in contraction in the medium term - with the resulting threat of an increase in disputes and contractor insolvency.

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Clients must therefore watch their contractors closely in coming months for any evidence of distress. But there is a delicate balancing act to be achieved – the clients who respond best will monitor, support and collaborate with their suppliers in equal measure.

In practical terms, this means re-running credit checks and challenging suppliers on their ability to continue delivering, while also seeking to understand and allay their concerns.

To do this successfully will require empirical analysis of each supplier's earned value, and expertise in the management of the whole supply chain – inclusive of Tier 3 suppliers.

The aim should be to establish the financial robustness of the supply chain while also strengthening relationships within it.

In other words, clients should seek to put an arm round their suppliers, while simultaneously keeping their eyes wide open for any sign of weakness.

2 Contract commitment and liabilities

In normal times, contracts offer protection for both clients and suppliers – a defence against unpleasant or unexpected change.

However an event as seismic as the UK's surprise vote for a Brexit may test existing contracts, and their interpretation, to the limit.

The referendum result, and its as-yet-unknown consequences, may not have been foreseen in the drafting of some contracts or procurement strategies.

Alternatively, parties may seek to argue that unexpected changes in statute introduced as part of the Brexit process could invalidate certain contractual agreements.

Clearly such a prospect represents a major liability for clients, so it is essential they review thoroughly all existing contracts for any such exposure.

This should be done as part of a contract health check or scenario-testing of the baseline cost, scope, risk and schedule to give the client a clear picture of what they have paid for, and – based on an updated risk management profile – what their future commitments and liabilities will be.

Clients with multi-stage programmes should also revisit the funding arrangements for the later stages. Major infrastructure programmes in particular may need to reconfirm the availability of funds from the European Investment Bank.

If there is any risk of pre-agreed but as yet undelivered funding being taken off the table, clients must urgently readdress their funding mix.

Finally, the review should also consider how contract risk is allocated across the supply chain and factor in the payment schedule – for example whether the client has committed to lump sum payment – before taking a view on where any contract risk lies.

Such a detailed assessment will be an invaluable protection against a supplier seeking to renegotiate or break a contract. It will give advance warning to the client of where their risk lies, and by identifying where the supplier's risk lies, will also provide a powerful lever for negotiation in the event of a dispute.

3 Cost base

Turner & Townsend's latest ICMS analysis, which was completed before the Brexit referendum, predicted overall cost inflation to soften this year to 4.9 percent in London, and three percent or above in every other UK region.

UK construction is heavily reliant on imports – both of materials and labour. More than 60 percent of building materials used in Britain are imported from the EU, and official figures show that nearly 12 percent of the industry's 2.1m workers come from abroad.

Responses should be intelligent and considered, and organisations should resist the temptation to get carried away by the mawkish speculation being indulged in by much of the media.

The abrupt fall in the value of Sterling – which sank to a 31-year low against the Dollar in the aftermath of the Brexit vote – has had an immediate inflationary impact on imported materials.

Sterling exchange rate volatility means that unhedged orders for foreign materials now represent a major liability, and clients should investigate whether they can be substituted for alternatives. British manufacturers and suppliers should be cheered by the opportunity that this creates.

In this environment with the medium-term risk of contraction, we expect contractors to be less selective about the projects they may take on, more compliant on preliminaries pricing and more competitive in their pricing of overheads and profits.

From a client's perspective it's essential to work with suppliers to understand where their project resources, major plant and equipment and building materials are being sourced, and when their payment commitment dates are.

The outlook is not necessarily all bleak though. What is not yet clear, is the immediate impact of the referendum decision on inward investment, which could be positive.

Strategies that reduce the length of time spent on site, such as the use of off-site pre-fabrication, greater automation and end-to-end use of building information modelling (BIM) will be crucial, and clients should look to incorporate elements of them into their project.

4 Project controls

Robust project controls serve a twin purpose – as both guarantor of efficiency and as an early warning system.

They are never more important than in the current climate of uncertainty, and clients should dial up the levels of scrutiny on all aspects of their projects.

In many cases this will mean using existing control tools more intensively – for example holding fortnightly rather than monthly progress meetings – but organisations should also review and update their opportunity and risk registers to reflect the new reality.

With the process of Brexit expected to take more than two years, the current uncertainty will not be short-lived. Organisations' responses shouldn't be either.

Organisations and their programme managers should seize this opportunity to revisit their project baselines, using detailed records of the execution plan.

With the full impact of Brexit still largely unknown, those who increase the robustness of their project controls and performance management systems will benefit whether they identify issues or not.

Where problems are identified, corrective action can be taken. Where no problems are found, the organisation will enjoy a reassurance dividend that will trickle down the supply chain.

Cool heads and considered responses

For all the wild speculation about the long-term impact of Brexit, the immediate impact is easier to quantify – continuing uncertainty, rising costs, deferred investment and pressure on the supply chain.

While uncertainty itself is a risk factor – and by definition a difficult one to calibrate – its more obvious symptoms can be adjusted for and treated. For organisations currently engaged in capital asset programmes, now is the time to take stock of the situation, identify specific risks and liabilities, and take pre-emptive action.

Responses should be well considered, and organisations should resist the temptation to get carried away by the mawkish speculation being indulged in by much of the media.

And it's worth remembering that unlike the global financial crisis, the Brexit fallout is being felt most acutely in the UK. While its impact is rippling across the EU and to a lesser extent the US, falls in UK commercial property values combined with the weak Pound could unlock opportunistic investment appetite from overseas.

Construction is a famously cyclical sector, well used to absorbing the peaks and troughs of the economic cycle. The prolonged period of uncertainty triggered by the UK's vote for Brexit has amplified existing trends rather than created new ones.

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The clients that we have supported to adopt a measured approach and who address the four impact areas outlined above are able to successfully mitigate many of the risks they currently face.

As the UK embarks on the formal process of Brexit, new challenges will emerge. Tactics will need to evolve in response, but a strategy that includes robust project controls and a commitment to a collaborative supply chain will enable clients to continually anticipate, adapt and achieve the best project outcomes.

About Turner & Townsend

Turner & Townsend is an independent professional services company specialising in programme management, project management, cost management and consulting across the property, infrastructure and natural resources sectors.

With 90 offices in 38 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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