NOVEMBER 2022

BUILDING REPAIR COST REVIEW

Quarterly update: based on data from August 2022 to October 2022

The review

Each quarter, Sedgwick's repair solutions quantity surveying team reviews the building and construction market to understand the primary drivers of cost and ensure that our rates remain competitive. This report provides an overview of the current situation and looks at the issues that could potentially impact insurers' building repair costs over the months ahead.

We've previously advised our inflation forecast for 2022 was 10%. We've continued to monitor cost increases and we've now recorded these at 10.82% YTD. We expect, however, there may be an element of fall back in some costs in Q4 as certain material costs drop. Inflationary pressures previously reported on, i.e. the effects of Brexit, global shipping difficulties, the pandemic, the war in Ukraine and rising energy costs continue to be relevant.

The political and economic turmoil of Q3 has impacted construction and the loss of consumer confidence is now also pointing to a possible recession in the industry.

Updates

- From January to the end of September, we recorded an increase in costs of 10.82%
- Merchants continued to notify material increases, e.g. October rises of 14% for cement, 9% for blocks and 28% for bricks
- Data indicates that increasing tender costs continue to reflect rising market costs
- Home emergency material costs show year-to-date increases of over 25%
- We forecast inflation in 2023 to be in the region of 6%. This assumes stability in the market and that as a result material costs will start to fall
- There are indications of a recession in the short to medium term

PETER WASSELL
Technical director

M +44 7880 780673
E peter.wassell@uk.sedgwick.com

Building cost inflation

To track the impact of inflation on insurance repair work within the building industry, we use our own index that focuses specifically on this market. We call this the Insurance Repair Specific Index (IRSI). It monitors the four main cost components typically found in insurance repairs: labour, plant, materials and waste disposal.

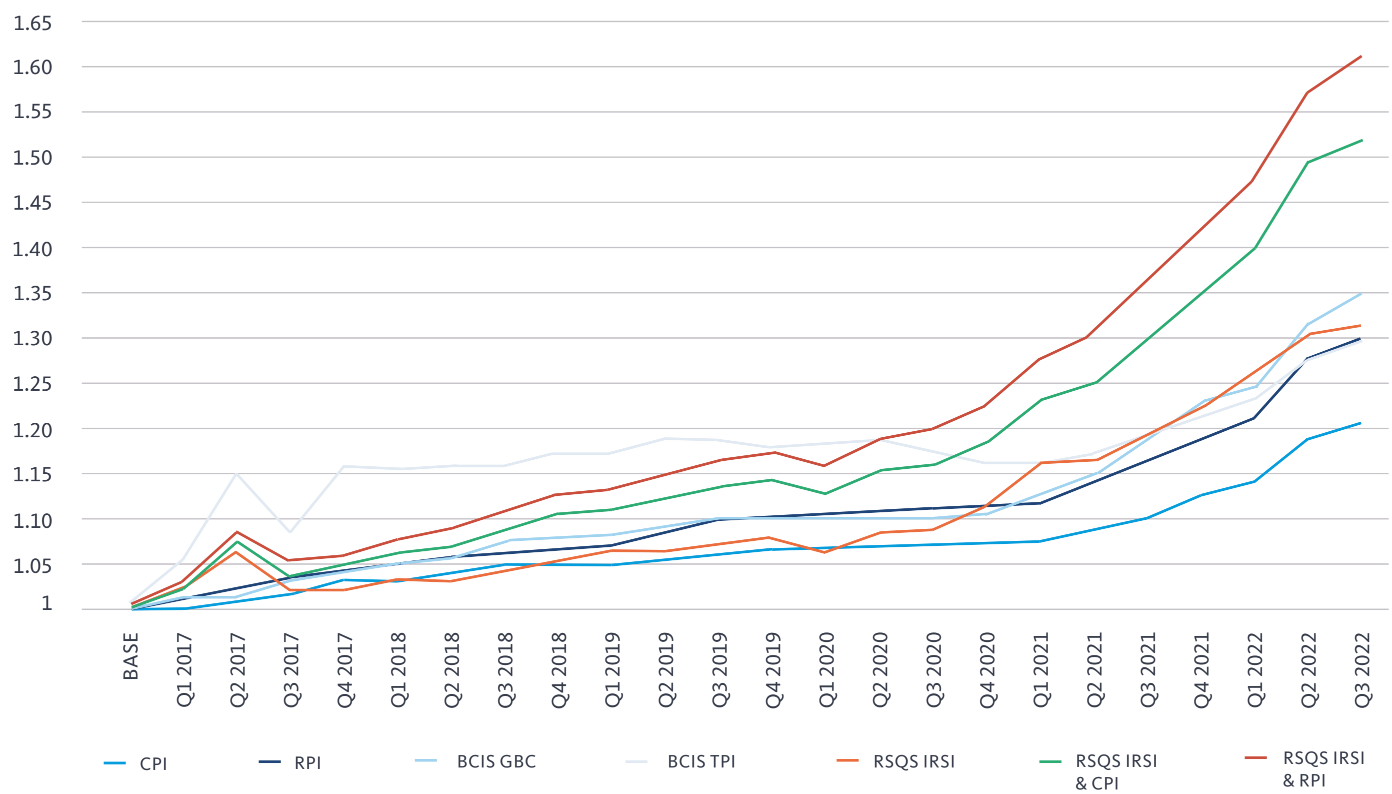
Positive cost inflation has continued, and the latest IRSI and a detailed review of typical material costs show that input costs increased from January to the end of September by 10.82% as shown in table 1 below.

Over the quarter, builders' merchants have continued to issue price increases. In a notification at the beginning of October, one national merchant gave a blunt explanation.

This approach illustrates how builders working on fixed price contracts (e.g. tenders, schedules, rates) then have difficulties in maintaining reasonable profit margins when they aren't able to increase costs they pass on to clients.

"Our suppliers are continuing to experience extreme cost price inflation which is reflected in the price increases across the below categories for October. The rising cost of energy (electricity, gas, fuel), packaging, transport and raw materials continue to be the main areas of this inflation. We are therefore forced to pass these costs onto our customers. Although trading is challenging at the moment, to improve our profitability we need to prioritise passing on these increases to our customers".

Table 1 – Insurance Repair Specific Index (IRSI)



The table above shows how the IRSI compares to the other key indices – the Consumer Price Index (CPI), the Retail Price Index (RPI) the Building Cost Information Service General Building Cost Indices (BCIS GBC) produced by RICS, the BCIS Tender Price Index, Sedgwick's repair solutions quantity surveying (RSQS) IRSI, RSQS IRSI & CPI and finally RSQS IRSI & RPI.

There has been some brighter news with signs that the scale of increases is slowing and there have also been price decreases of some timber products. Merchants have also said:

"The good news is we have started to see the easing of supply issues and allocation of products to our branches, and, in most cases, we are back to full allocation meaning we have stock readily available".

All of the reasons for construction inflation covered previously remain; the most important factor is now energy costs. The increasing costs of electricity and gas is affecting all components but especially those where production is energy intensive such as bricks, and steel. The awaited Energy Bill Relief Scheme will be important in determining material costs over the next few months.

There are signs of a potential construction recession. The changing political environment is causing some concern that the government may now introduce measures to cut or reduce infrastructure expenditure. The HS2 project, for example, is exceeding initial cost estimates, in part because of material inflation, e.g. steel increasing from £800 to £1200/tonne, and there is speculation that this project may be scaled back. Commentators have raised concerns that a reduction in infrastructure spend will lead to a recession in construction generally. The Federation of Master Builders, which represents small construction businesses, has also reported that members have advised of a recent and significant fall in new work enquiries, especially in Scotland and Northern Ireland. This is also leading to speculation that this fall in demand will lead a recession. Consumers need confidence to spend on property work and this seems to have been damaged by the cost of living crisis.

However, there are some conflicting aspects. Firstly, Michael Gove, Housing Secretary, has committed to the building of 300,000 homes per year. That will need a healthy domestic construction industry, with capacity, to reach this challenging target. Secondly, the government remains committed to a carbon neutral economy by 2050, which will require large scale improvements to the 28 million homes in the UK, again needing a strong domestic construction market. The issue faced is the supply of competent labour. A recession will shrink the labour pool, but the government must have policies in place which support construction if tradesmen are to be retained. Contractors continue to report difficulty in recruiting carpenters, joiners, bricklayers, and general labourers, and where candidates are available, they are demanding premium rates. Reports have been given of plasterers outside the London conurbation now earning £1000 per week. Contractors working in insurance repair find it difficult to agree salaries in that region.

Costs of home emergency repair work have continued to rise. A Checkatrade survey has shown an increase of 19% in small plumbing projects and merchants have recorded similar frequent material price rises similar to building materials. For example, one merchant advised increases on valves of 10% in September, 8% increases having been introduced in July. We track increases in plumbing material costs on our own index and have noted increases in plumbing materials of 27.65% and 23.57% respectively. The progression of increases since January is shown below in tables 2 and 3.

Table 2 – YTD increases in plumbing material costs

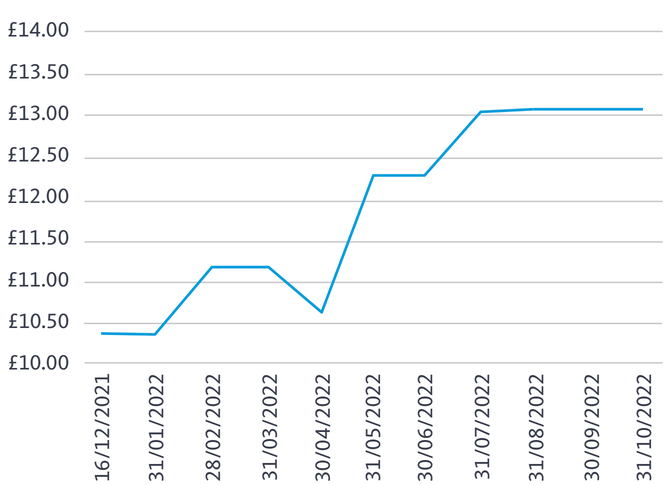


Table 3 – YTD increases in adhesives and sealants

Rates benchmarking

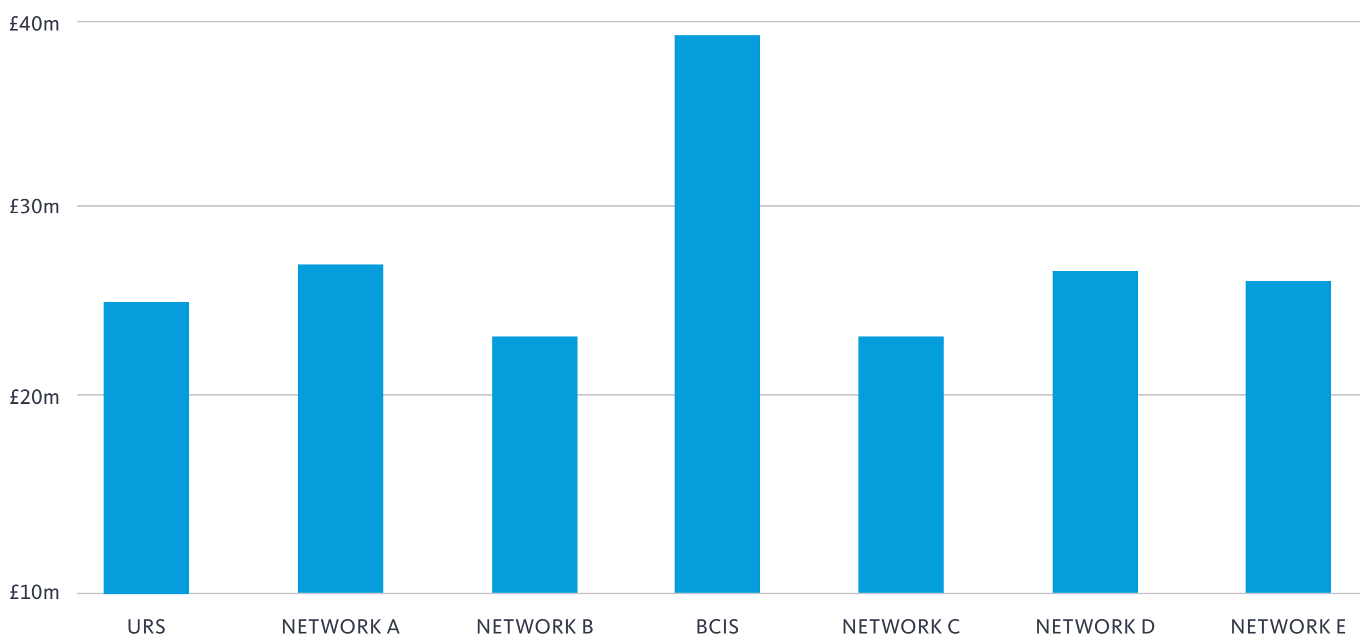
To ensure that Sedgwick's repair costs are competitive, our quantity surveying team undertakes a quarterly review of our repair rates – known as the universal repair rate (URS). The URS is compared with other market repair costs. This benchmarking exercise includes:

- A cost review of 25 of the most frequently used repair rates
- A review of the output costs of repairs on typical £5k and £25k escape of water claims
- A review of the output costs typical of flood, subsidence and fire repairs

The results of this review are shown in table 4 below. The URS remains competitive. It's important to note that our rates include all network management costs or fees. To allow comparison, 10% for management costs has been included with the net rates of other networks.

Rising contractor costs indicate some repair rates may need increasing to combat inflation.

Table 4 – Benchmarking



Dynamic pricing

Sedgwick's quantity surveying team also conducts a specific benchmarking exercise to compare the URS with wider market tenders. This provides a good indication of the competitive nature of URS against tendered repair jobs, which are typically at the higher value end (greater than £50k), and how market costs are increasing.

The annual portfolio review involves applying URS rates and rules and comparing the results with tenders received from panel contractors or the customer's preferred building firm. The analysis benchmarks the Sedgwick's repair solutions quantity surveying figure against:

- The lowest cost tender
- An average of the lowest two tenders
- An average of all four tenders (lowest quartile)

This indicates market pricing of repairs by evidencing the spread of tenders presented. The most recent analysis (as shown in tables 5 and 6 below) is as follows.

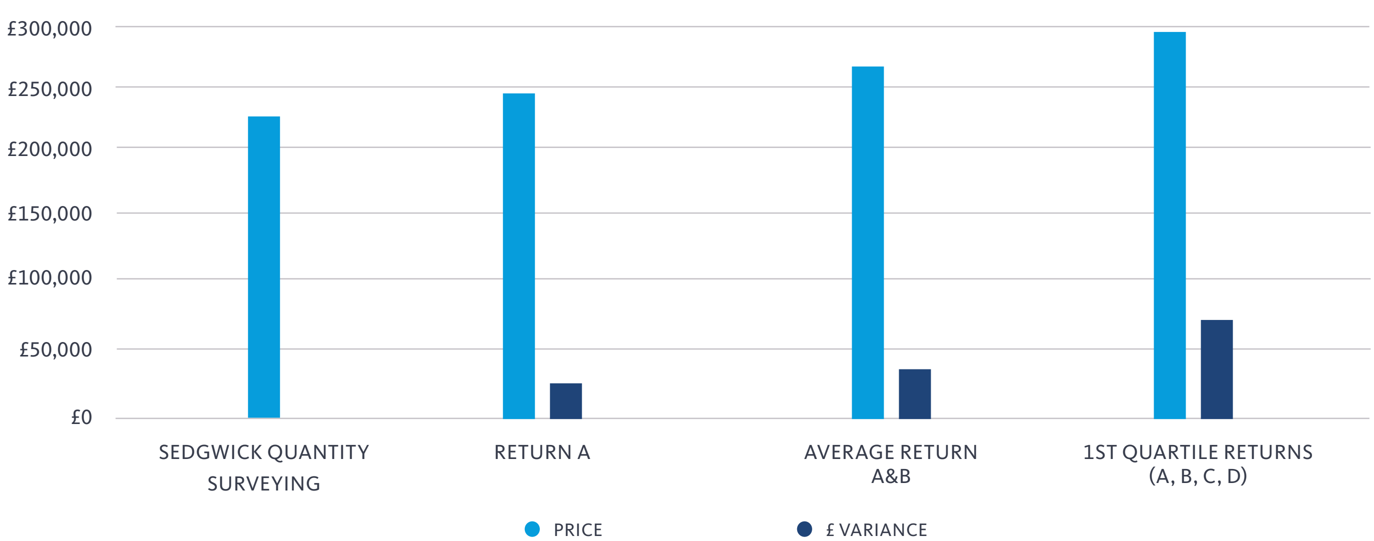
The dynamic pricing shows the increase in tender cost compared to rates. In the sample, we have four cases in this quarter three period. The comparison continues to show that contractors' pricing reflects the availability of profitable work and contractors selecting projects. The increase is, however, slightly higher than found last quarter, albeit the sample is small.

The use of rates also indicates a saving of around 20% compared to the open market. Table 6 illustrates the variances.

Table 5 – Dynamic pricing cost savings

	Sedgwick quantity surveying	Return A	Average return A&B	1st quartile returns (A, B, C, D)
Price	£225,984	£248,450	£264,814	£294,689.36
£ variance		£22,466	£38,830	£68,705.40
% variance		**9.94%**	**17.18%**	**30.40%**

Table 6 – Dynamic pricing comparisons



Contractor challenges

The construction sector is facing significant challenges. In our last report we explained results of our contractor survey where we asked how unique the situation is. The responses are well summarised by one comment we received:

> *"Utterly off the scale on most levels. I have been through numerous recessions and moments of high activity. What makes this set of variables so unusual is the unpredictability..."*

Since our last report there has been much commentary and speculation about the possibility of a recession in construction.

In the latest Office for National Statistics (ONS) report on insolvencies, they highlight the impact inflationary factors are having upon construction firms. The year to June saw the highest recorded level of insolvencies since the 2008 financial crisis, with a monthly average of 347 firms across the year to date. This follows the strong demand for construction work we've reported, which has been seen since the easing of Covid restrictions.

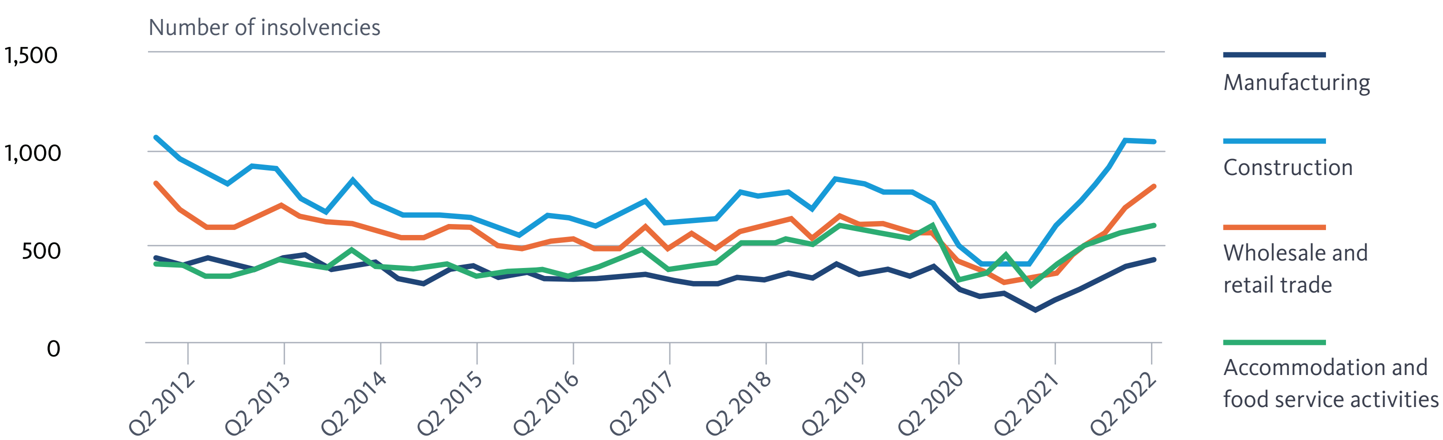
Industry analysts have identified high costs and unsustainable debt levels post-Covid. Coupled with rising energy costs, this is increasing the number of firms at risk of insolvency. One agency has reported that 79,000 construction related companies are in significant distress.

There are a number of reasons we'd suggest, which highlight why this is happening, and why a recession may be likely:

- **Debt.** Many construction companies increased borrowings during the pandemic and rising interest rates are increasing the level of payments needed. In the insurance sector, contractors also often experience delays in receiving payment for works done which leaves the contractor financing these in the short term – again increasing debt costs.
- **Cost increases.** Some contractors find themselves contracted to carry out work which is now costing them more than when agreements were entered into. Usually cost increases can be foreseen, however the events of the last 18 months are without precedence. There have been some reports of understanding clients allowing renegotiations.
- **Demand.** If demand for construction falls, contractors find that a shrinking order book doesn't allow costs to be recovered, which are needed to support an organisation geared up for certain work levels. Consumer confidence is important to maintain a strong domestic construction market and there are signs that's being lost.

We're working closely with our network contractors to navigate through this difficult time.

Table 7 – ONS insolvency trends



Company insolvency trends in selected industries, England and Wales, Quarter 1 (Jan to Mar) 2012 to Quarter 2 (Apr to Jun) 2022 sedgwick

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