



**AKERLOF**

**Coronavirus COVID-19  
Recovery Reinvented**

Supporting our clients, colleagues and industry to a new landscape

**AKERLOF**

# Recovery Reinvented

COVID-19 continues to affect lives, livelihoods, communities and businesses worldwide. In addition to the deadly human toll and disruption to millions of people's lives, the economic damage is forecast to be significant and far reaching.

Reports from the Bank of England suggest the economic impact will portend a recession deeper than anything seen for the past 300 years. In the face of evolving circumstances, business leaders are challenged to interpret developments, act nimbly to secure control and guide their teams to prepare for and shape a 'new normal'.

Second in our series of publications, this summary is intended to support senior leaders to evaluate the landscape; to navigate the effects of the coronavirus and aid in planning responsible measures that protect their stakeholders and businesses in an uncertain future.

We look forwards, assessing the shape of a potential market response within the construction industry, considering the risks of volatility, the challenges and opportunities for reinvention.

**The future is not what is used to be – recovery is being reinvented**

# The economic impact is under debate...

Swiftly following the Bank of England's estimated decline in world GDP of over 20%, Rishi Sunak has acknowledged that the UK has moved into a significant recession. For the year as a whole, the economy is expected to contract by 14% - the sharpest annual contraction since 1706.

The long-term impact of the shift however remains unclear.

**“It is hard to know how long it will be before normality returns, or what normality will look like.**

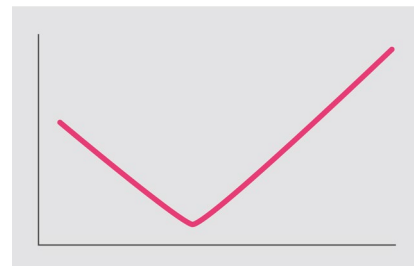
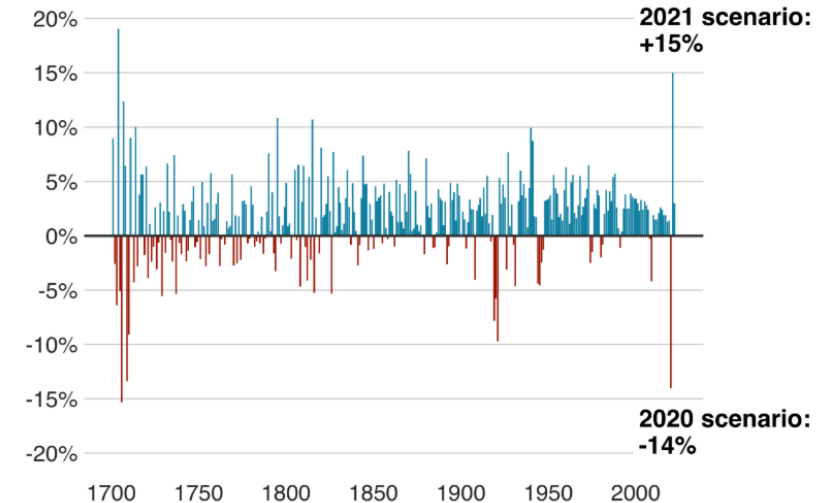
**The Economist**

In China, restrictions have started to ease, with economic activity slowly resuming. High-frequency indicators such as energy consumption and road traffic suggest that activity is at almost 90% of normal levels. It is unclear, when or if the UK will follow suit.

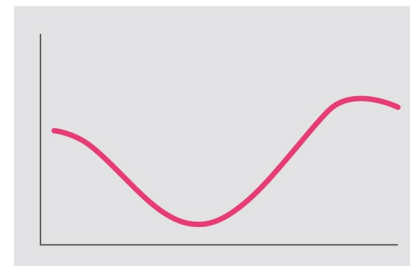
Seeking to inject market confidence, Sunak has continued to insist that the UK economy would be able to recover 'quickly and strongly' after the crisis was over. The Bank however, has stressed that the outlook is 'unusually uncertain' – demonstrated by diversity of scenarios raised by Reuters poll of over 50 economists:

## UK facing sharpest downturn since 1706

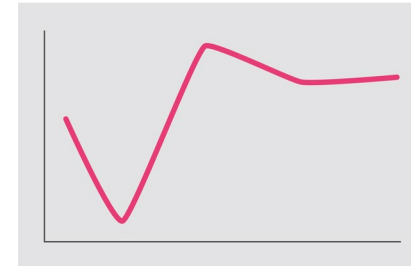
Historical UK GDP



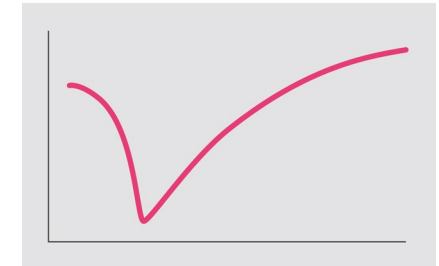
**V-Shape:** The best outcome  
A growth plunge, followed by a sharp recovery



**U-Shape:** When recovery takes more than a couple of quarters.



**W-Shape:** A double-dip – easing boosts activity but effects filter through over time



**Swoosh:** A sharp downturn, with gradual recovery as lockdown is eased.

# Challenges on the ground...

The behaviour of the future economy is difficult to predict at the best of times; the pandemic has upended norms and conventions. Like most macro-economist forecasters, the Construction Products Association (CPA) have adopted the V-Shape or Swoosh to scenario plan. Theoretically this is positive news – construction activity having a strong correlation with economic growth – however the realities at a working level are somewhat different.

With the Prime Minister urging the construction industry to return to work, businesses have been left challenged to protect the health of workers, manage client and supplier relationships and contracts, whilst seeking to maintain productivity and financial stability. Well-intentioned, the Construction Leadership Council have published a fourth version of its Site Operating Procedures, however the industry continues to wrestle with the practicalities of safe working. The extent of inefficiencies and non-productivity are varied - unique to the project specifics

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67% Productivity on  
Construction & Infrastructure  
Sites and 56% on London  
Sites

Build UK  
30<sup>th</sup> April

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50% Revenue compared to  
same period in 2019

Marshalls  
12<sup>th</sup> May

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85% housebuilding  
80% commercial build  
60% non-residential new build

Output lost in April: CPA  
10<sup>th</sup> May

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Parallel to onsite challenges, large parts of the material and component supply chain have suffered disruption and reduction in activity. Travis Perkins reported it has furloughed half of its 30 000 staff, with only 21% of building merchants fully open, as 11<sup>th</sup> May. Irrespective of labour availability, most projects have struggled with continuity of material supply.

Varying interpretation of the risk ownership of the time and cost impact under existing contracts is anticipated to add further tension along an already stressed chain.

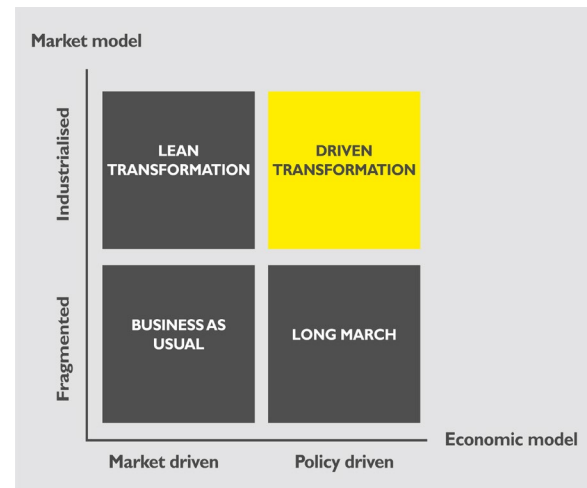
# Unpredictable market at the best of times...

Contributing circa 7% of GDP and creating £2.92 of value for every £1 spent, the construction is pivotal to the UK economy. Recent months have reaffirmed the value of the sector beyond pure metrics – our infrastructure and environment shaping our wellbeing, our sense of community, security, our experiences and capacity to remain connected

Whilst Department for Business, Energy and Industry Strategy (BEIS) and the infrastructure Projects Authority (IPA) have signalled that a public sector recovery plan is being drawn up, investor confidence in the private sector remains fragile. The RICS Future Trends Survey revealed that 40% of pre-construction projects have been put on hold since the start of March, whilst at a broader level demand and use requirements for property change.

**“Right now, it is impossible to determine what will happen to real estate investments.**

**PricewaterhouseCoopers**



The same societal shifts in response to COVID-19 that are proving disruptive, may equally present the industry with a unique opportunity to realise ‘Driven Transformation’.

The pace of the ‘escape velocity’ is yet to be seen.

## Animal Spirits



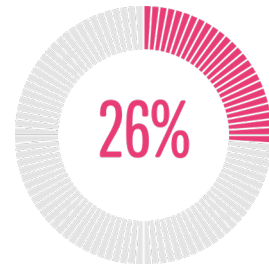
Many commentators have challenged the comparisons between the 2008 global financial crisis and current circumstances, citing key differences. Rationally this is true, however Nobel laureate George Akerlof reminds us that human psychology, emotion and sentiment, drives the economy.

Detached events can provoke other unrelated ones; the Asian currency crisis and Russian crisis of 1998 were chronologically distinct however the memory and mentality of investors bound them together.

For this reason, we are cautious not ignore the influence the events of 2007-2011 may bear on current circumstances, not least the memories of those within board rooms today.

# Pricing in a rising market...

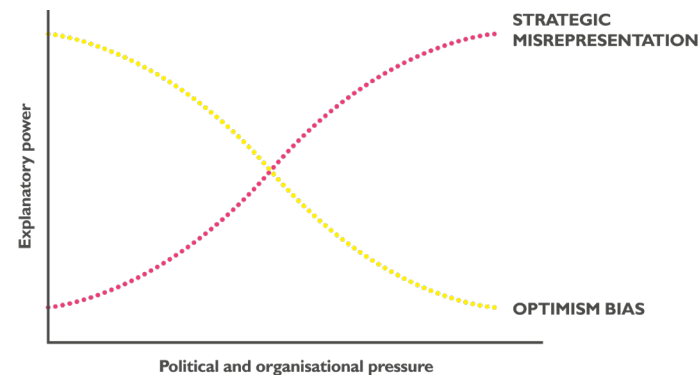
Construction activities has historically had a strong correlation with economic growth but tended to be three times more volatile. Whilst the prospect of an upward demand curve is positive, assuming a lagging risks of price escalation in a volatile environment is not without complication.



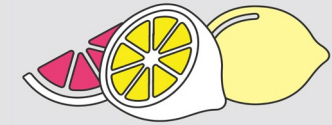
The previous recovery resulted in 26% rise in tender price between 2013 and 2016

CBI report “Fine Margins” outlined a clear view that a better approach to risk can raise the quality of the industry and support businesses large and small to thrive. Historically however, in deflated markets when faced with a tendering equivalent to a prisoners dilemma, a contractor’s need to secure turnover has often overtaken their capacity to manage or mitigate the future risk of a rising market.

With mounting pressures, discerning leadership is required to avoid a Market for Lemons, or worse still, organisational hari kari borne of optimism or misrepresentation.



## Market for Lemons

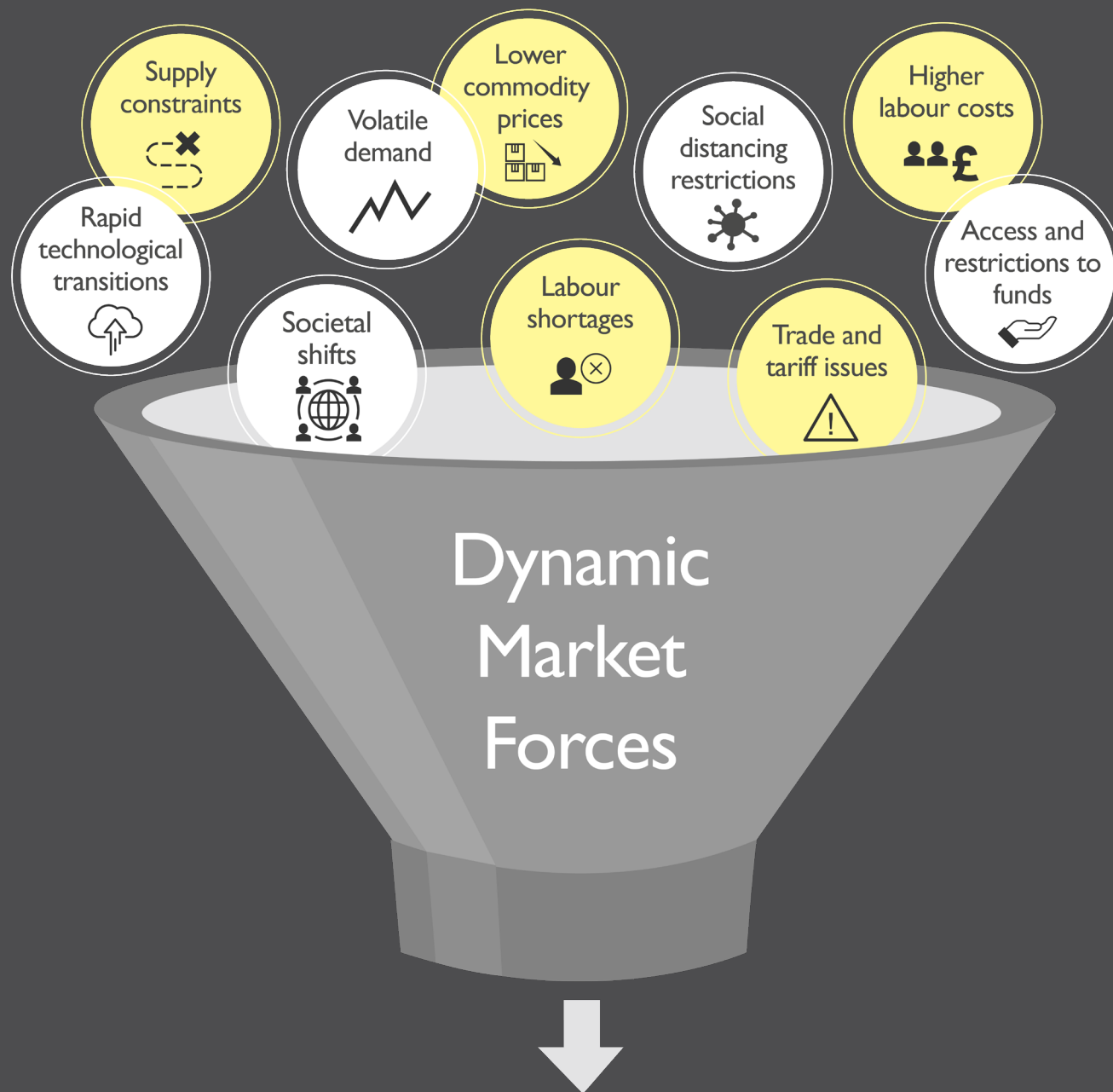


Within his seminal paper, the ‘Market for Lemons’, George Akerlof demonstrated the devastating consequences of adverse selection under conditions of quality uncertainty and unequal (asymmetric) information.

His example was not fruit nor construction but used cars – a ‘lemon’ being one with hidden defects. Buyers want quality cars or ‘peaches’ however to account for the risk the car is a lemon, buyers cut their offers. That puts off peach-sellers, some of who exit the market, raising the likelihood of buyers getting a lemon, pushing prices down further.

It becomes impossible to sell quality (a peach) for what is should be worth and therein lies the tragedy: there are buyers who would happily pay the asking-price for a peach, if only they could be sure of the car’s quality. This “information asymmetry” between buyers and sellers kills the market.

If this dynamic wasn’t challenging enough, in a recession the forces driving prices downwards only serve to exacerbate.



Market forces and their economic implications are difficult to predict. In a groundbreaking study, psychologist Philip Tetlock analysed forecasts from 284 experts from a variety of fields.

Soliciting roughly 28,000 predications about the future, Tetlock found that forecasters were only slightly more accurate than chance and usually worse than basic extrapolation algorithms.



**An unbiased appreciation of uncertainty is a cornerstone of rationality – but it is not what people and organisations want”**

**Daniel Kahneman (Nobel Prize Winning Economist)**


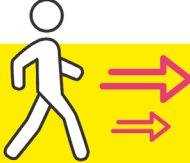

At Akerlof, we acknowledge uncertainty and respect the limitations of forecasting, but work hard with organisations to scenario plan - realistic but prepared nonetheless.



# What we say isn't always what we do...

In their excellent update “A New Paradigm”, Cast Consultancy have sensibly advocated that projects are reappraised for the new market; encouraging a move towards “early design stage consideration and optioneering of Modern Methods of Construction and innovation in more collaborative and integrated procurement models with more resilient supply chains”.

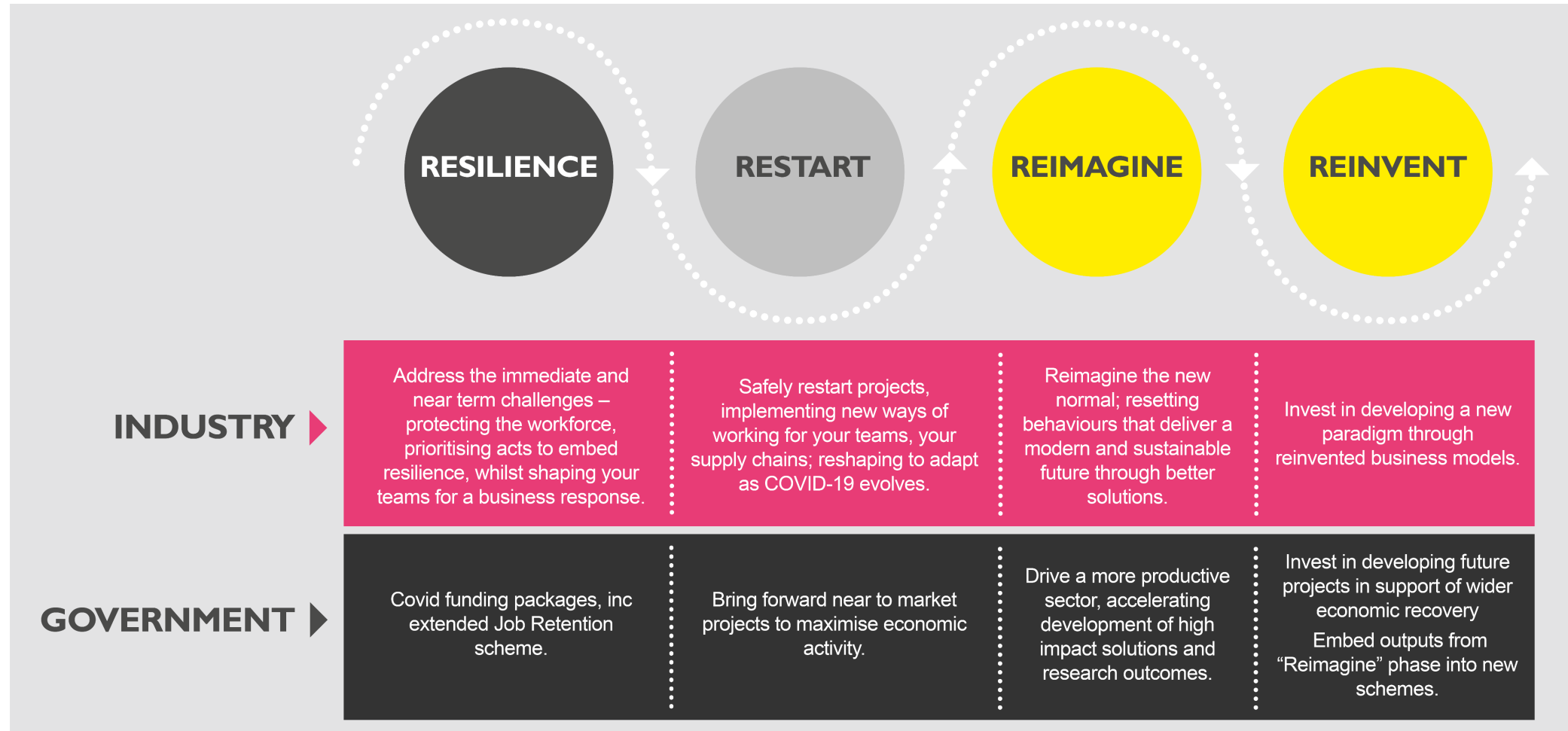
Whilst much of the industry supports this principle, it is questionable as to whether behaviour will necessarily follow suit:

 <b>WHAT PEOPLE SAY</b>	 <b>REALITY</b>	 <b>ISPO FACTO</b>
They don't want to stalk their friends	There is little in this world they want more than to keep up and judge their friends	Mark Zuckerberg, cofounder of Facebook is worth \$77.8 billion
They have no interest in reading about bondage, dominance and sadomasochism	They want to read about BDSM between a young college graduate and a business magnate	50 Shades of Grey has sold over 125 million copies
They don't want to buy products that are produced in sweatshops	They will buy 'reasonably priced products'	Phil Knight, cofounder of Nike is worth \$35.2 bn
They want equitable, balanced risk allocation with the market	They will attempt to transfer risks, without analysis or understanding	Carillion
They want to accelerate industry modernisation	They want to protect the status quo, where it suits	Flat productivity for past two decades
They understand the importance of cashflow to the supply chain	Cash is king for everyone - they want to retain it as far as reputationally permissible	Average payment terms for Build UK members were at 45 days (now at 36 days)



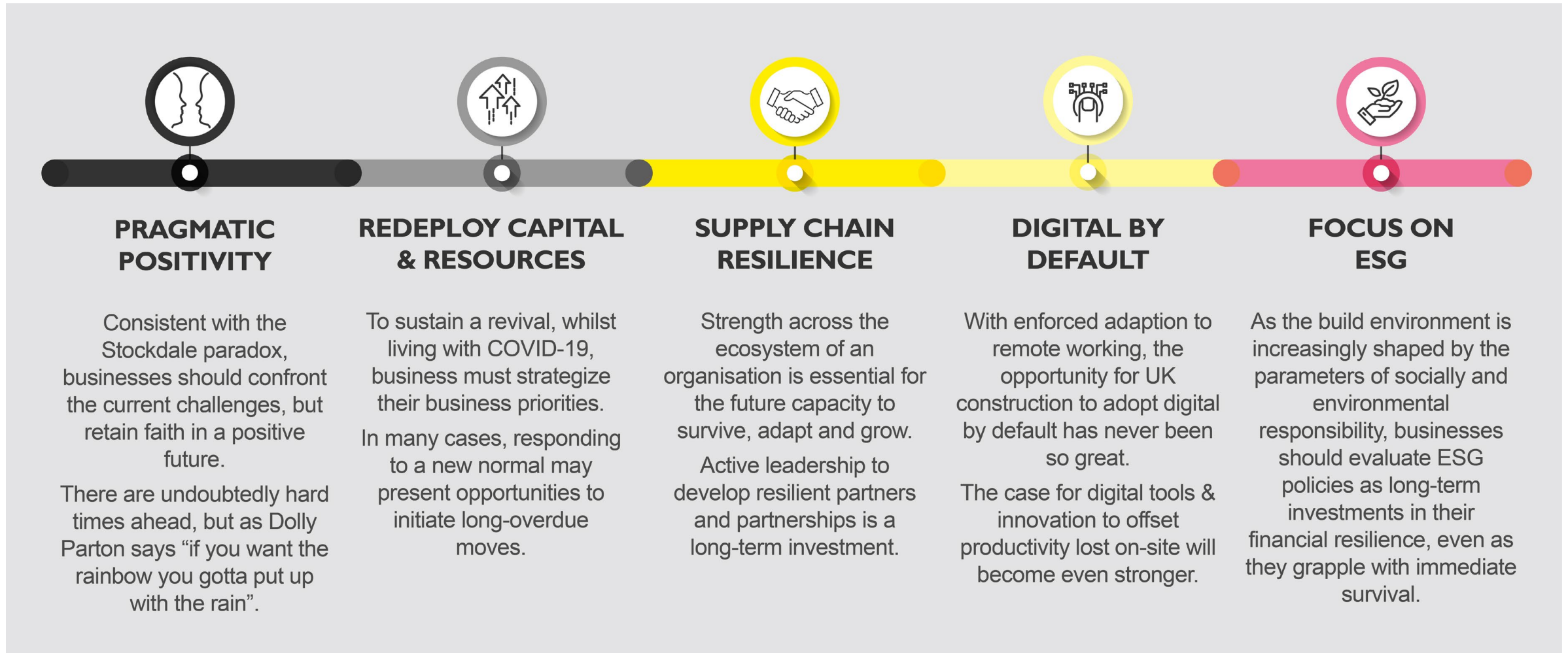
# Model of reinvention

As industry leaders seek to navigate the immediate challenges and embed resilience within their businesses, we propose a 4-stage model that looks towards establishing new plans that reshape, reimagine and reinvent.



# A better future

It is the time to start reimagining our industry and how businesses can emerge from a position of strength. As leaders look to reshape their agendas, we outline our 5 point plan, as a framework to help prepare:



# Knowledge share...

Education, knowledge share and lifelong learning are core to our values and essential to the development and sustainable growth of our industry.

We've therefore created space to highlight material that we have found useful in understanding the implications of COVID-19. We hope you find them helpful: [www.akerlof.co.uk/knowledge](http://www.akerlof.co.uk/knowledge)

Within our 'Knowledge Share' you will find links to guidance articles by the World Economic Forum on stakeholder principles and world leading insight from McKinsey and Deloitte, amongst others.

In our next release, we'll be providing a summary of the benefits of offsite solutions and how adoption of platform based solutions (P-DfMA) can unlock value to businesses in the current climate.

# **We're here to help...**

Akerlof is a leading consultancy that specialises in integrating change with a focus on new ways of working in the built environment.

We can help your business develop or implement a plan in uncertain times.

**AKERLOF**

EXPERTS IN MODERN METHODS OF CONSTRUCTION

**[akerlof.co.uk](http://akerlof.co.uk)**