UK Inflation Report

GDP growth continues at slowing pace

CPI remains close to 0%

Unemployment rate at 7 year low / Employment rate at all time high
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Introduction

Gleeds’ Economic Report assesses and summarises the factors affecting UK construction, taking into account inflation, construction output and orders, employment, and other topical matters.

Looking back...

Construction output

According to the Office of National Statistics (ONS), construction output decreased by 2.2% in Q3 2015 compared to Q2 2015.

When compared to Q3 2014, construction output has decreased by 0.1%

The marked weakening in construction output growth over the past 12 months may be partly related to an earlier slowing in housing market activity. However, Bank of England research indicates that construction activity may be stronger than the official data suggests.

Construction orders

New orders in Q2 2015 were down by 0.4% compared with Q1 2015 (although Q2 2015 shows a 1.9% increase compared with Q2 2014).

Orders for private new housing, public new housing and other new work decreased by 2.6%, 12.7% and 5.5% respectively between Q3 and Q2 2015.

All repair and maintenance decreased by 2.1% in Q3 compared with Q2; public housing repair and maintenance and non-housing repair and maintenance reported falls of 4.2% and 2.3% respectively.

Pay and employment

In Q3 the unemployment rate fell to a 7 year low of 5.3%; this is 0.3% less than the previous quarter (5.6%) and 0.7% less than 12 months earlier in Q3 2014 (6.0%). This is the lowest reported rate since April 2008.

Average weekly earnings (total pay) in the construction industry rose by 4.6% between September 2014 and September 2015.

Gleeds’ regional inflation forecast

ANNUAL % CHANGE

<table>
<thead>
<tr>
<th>Region</th>
<th>Q4 15 to Q4 16</th>
<th>Q4 16 to Q4 17</th>
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<th>Q4 18 to Q4 19</th>
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<td>5.0%</td>
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<td>3.5%</td>
<td>3.0%</td>
</tr>
<tr>
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<tr>
<td>MIDLANDS</td>
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<td>SOUTH EAST</td>
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<td>4.5%</td>
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<tr>
<td>SOUTH WEST</td>
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<td>5.0%</td>
<td>5.0%</td>
</tr>
<tr>
<td>WALES</td>
<td>4.0%</td>
<td>4.5%</td>
<td>4.5%</td>
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<tr>
<td>UK AVERAGE</td>
<td>4.9%</td>
<td>4.6%</td>
<td>4.6%</td>
<td>4.3%</td>
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</table>

Note: these are average regional forecasts based on activity and market awareness within each of our regional offices. Actual inflation will be determined by a combination of macroeconomics and micro project situations. Consequently, forecast inflation at a project level needs to be carefully considered based on the project’s characteristics and prevailing local conditions. Published statistics can be misleading and subject to later revision, and should be used with caution.

"Construction output continues to gain strength across all UK regions, despite statistics suggesting otherwise." 
Ross Savage
Director, Gleeds
In the Euro area, Gross Domestic Product (GDP) rose by 0.4% in Q2, supported by a pick-up in export growth and increased household spending, which may have been influenced by the fall in energy prices. A similar level of growth is expected for Q3, showing little influence from the Greek debt negotiations over the summer.

With growth in GDP expected to slow in 2015 and, given the historic relationship of construction output and GDP, it is possible that growth in construction output will also slow over the coming months.

Since Gleeds’ previous quarterly report, CPI has remained close to 0. The rate had fallen to -0.1% (from 0.0% in August) in September, where it remains in October. This was influenced by upward price pressures for clothing and footwear and a range of recreational goods being offset by downward price pressures for university tuition fees, food, alcohol and tobacco. Inflation is expected to pick up in the coming months, although it is anticipated to remain below 1% until the second half of 2016.

The Bank Rate has again been maintained at 0.5% in October. Rates are expected to remain at 0.5% before rising to 1.0% in 2016 and then 1.5% in 2017, 2.0% in 2018, and to 2.5% in 2019.

A slowdown in the growth of the Chinese economy could affect the UK given China’s standing as an important source of demand for commodities from the UK; it could intuitively cause commodity price falls. Should the slowdown become more severe, there could be fiercer implications for the UK economy, including the possibility of increased uncertainty and falls in asset prices.


Summary

- CPI inflation turned negative in September and has remained at/around 0% throughout the quarter
- This is the 9th consecutive month that inflation has been at or very close to 0%
- It is assumed by the Bank of England that the inflation will remain below 1% until the second half of 2016, following recent falls in oil and other commodity prices
- RPI fell to 0.8% in September and 0.7% in October, continuing its downwards trend
- GDP rose by 0.7% in Q2 2015 compared with the previous quarter. Growth in GDP is expected to slow by the end of 2015
- The outlook for global growth has weakened since reported in the previous quarter
# GDP, CPI & RPI Movement predictions

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<td>‡</td>
<td>2.4</td>
<td>‡</td>
<td>2.3</td>
<td>‡</td>
<td>3.2</td>
<td>‡</td>
<td>2.3</td>
</tr>
<tr>
<td>CPI (%)</td>
<td>0.1</td>
<td>‡</td>
<td>1.3</td>
<td>‡</td>
<td>1.9</td>
<td>‡</td>
<td>2.1</td>
<td>‡</td>
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<td>RPI (%)</td>
<td>1.0</td>
<td>‡</td>
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<td>‡</td>
<td>3.3</td>
<td>↔</td>
<td>3.3</td>
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<tr>
<td>Sterling index (Jan 2005 = 100) (HM Treasury)</td>
<td>90.7</td>
<td>‡</td>
<td>91.8</td>
<td>↓</td>
<td>91.7</td>
<td>↔</td>
<td>91.7</td>
<td>↓</td>
<td>91.3</td>
</tr>
<tr>
<td>Official Bank rate (annual average, %) (HM treasury)</td>
<td>0.5</td>
<td>‡</td>
<td>0.8</td>
<td>‡</td>
<td>1.4</td>
<td>‡</td>
<td>2.1</td>
<td>‡</td>
<td>2.6</td>
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</table>

*Movement relates to predictions from the previous quarter*
Retail Prices Index Inflation Forecasts

HM TREASURY Q4 2015

Inflation continues to be very low, but this may help boost spending over the coming months.

SARAH DAVIDSON
DIRECTOR OF RESEARCH & DEVELOPMENT
According to the Building Cost Information Service (BCIS), tender prices increased by 1.1% in Q2 2015 compared with the previous quarter and are expected to rise by 5.5% in the year to Q3 2016. The annual rate increase is beginning to slow and this is viewed as a sign that contractors are coping with the increase in workload. BCIS expects tender prices to continue to rise over the next 6 months.

Gleeds anticipates tender prices to rise over the next 4 years (Q4-Q4) at a UK average rate of:

- 4.9% between 2015-16
- 4.6% between 2016-17
- 4.6% between 2017-18
- 4.3% between 2018-19
Looking at the volume of construction output, the ONS reports that:

There was a **2.2%** decrease in all **construction output** in Q3 2015 compared with the previous quarter. This reverts to the declines of Q4 2014 and Q1 2015, following the previous quarter’s slight increase. Over the past 12 months, construction output has remained relatively stable with a **0.1%** decrease.

**All new work** in Q3 fell by **2.2%**, with public and private new housing and public other work decreasing by **12.7%**, **2.6%** and **5.5%** respectively. The only sectors to report increased output this quarter were infrastructure and private industrial.

**All repair and maintenance** in Q3 2015 (when compared with Q2) decreased by **2.1%**, with public housing repair and maintenance and non-housing repair and maintenance falling by **4.2%** and **2.3%** respectively.
Change in Output Figures for the Main Construction Sectors

Percentage change refers to Q2 2015 to Q3 2015 according to ONS

A comparison of output activity between Q1 2008 and Q3 2015 reveals that:

- All work is down by 4.4%
- Infrastructure is up 84.2%
- Private commercial is down by 33.7%
- New private housing is up by 6.9%
- Private industrial is down by 21.3%
- New public housing is up by 45.8%
- Repair and maintenance is down by 7.8%
- Other new public work is down by 2.1%
Value of Orders for New Construction in Great Britain

According to the ONS, the total value of new orders for the construction industry fell by 0.4% in Q2 2015 compared with Q1 2015 and increased by 1.9% compared with Q2 2014.

Comparing Q2 2015 with Q1 2015:

UK Employment

Following a slight increase in Q2 2015, the unemployment rate decreased in Q3 from 5.6% to 5.3%. This is the lowest rate reported since April 2008. In line with this, the employment rate increased to 73.7% in Q3, the highest level since records began in 1971.

Average weekly earnings (total pay) in the construction industry rose by 4.8% between September 2014 and September 2015. Pay for employees increased by 3.0% (including bonuses) and 2.5% (excluding bonuses) between Q3 2014 and Q3 2015.
The Q3 2015 RICS Construction Market Survey reports that the private housing and commercial sectors are continuing to drive growth in workload. 39% of survey respondents identified a rise in their workloads.

Respondents reported growth at 47% and 46% for the private housing and commercial sectors respectively. A more measured level of growth is reported for the public sector at 12%, and 21% of respondents report growth in the housing and non-housing sectors. The private industrial sector also continues to rise steadily, with 32% of contributors seeing an increase in their workloads. The infrastructure sector is seeing a higher level of growth than was reported in Q2 (34%, up from 25%).

Limitations to growth are cited to include financial constraints, skills shortages, and planning and regulatory issues (69%, 67% and 60% respectively).

Material shortages continue to decline in importance, currently affecting 38% of respondents. Domestic production capacity has increased to fill this gap.

The skills shortage is at its highest level since the RICS Construction Market series began in 1998; 53% of contributors report difficulty in sourcing labour. This is particularly the case for bricklayers (71%) and quantity surveyors (64%).

Competitive pressures from rivals is seen as impeding growth by 49% of contributors to the survey.
Capacity constraints are also becoming inhibitory; 61% of firms are reported to be operating at at least 90% capacity with 29% operating at full capacity. Due, in part, to this, contractors are becoming more selective about the projects for which they choose to tender.

Despite these constraints, the industry remains optimistic for the year ahead: 57% of respondents expect workloads to increase over the next twelve months and 47% expect employment levels to rise.

The Q3 2015 RICS UK Commercial Property Market Survey again shows a healthy rate of demand growth across both occupiers and investors, with improvement continuing all over the UK. Available supply, however, remains firmly in decline. Current market dynamics therefore continue to place significant upward pressure on rents and capital values.

RICS UK Commercial Property Market Survey Q3 2015
## Construction Output Summary of Forecasts

### CONSTRUCTION OUTPUT

<table>
<thead>
<tr>
<th>YEAR</th>
<th>EXPERIAN</th>
<th>CONSTRUCTION PRODUCTS ASSOCIATION</th>
<th>BCIS</th>
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<tbody>
<tr>
<td></td>
<td>% Q4 2015</td>
<td>% Q3 2015</td>
<td>MOVEMENT</td>
</tr>
<tr>
<td>2015</td>
<td>3.5</td>
<td>3.9</td>
<td>↓</td>
</tr>
<tr>
<td>2016</td>
<td>3.6</td>
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<td>2019</td>
<td>3.5</td>
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<tr>
<td>2020</td>
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### TOTAL NEW WORK

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<th>BCIS</th>
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<tr>
<td></td>
<td>% Q4 2015</td>
<td>% Q3 2015</td>
<td>MOVEMENT</td>
</tr>
<tr>
<td>2015</td>
<td>5.9</td>
<td>5.3</td>
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<tr>
<td>2016</td>
<td>4.3</td>
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<tr>
<td>2017</td>
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<td>5.8</td>
<td>↑</td>
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<td>2018</td>
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<td>2020</td>
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### PUBLIC HOUSING

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### PRIVATE HOUSING

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## Construction Output Summary of Forecasts (cont’d)

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Regional Reports

Reports from our regional offices suggest that in general, business confidence continues to improve and the outlook for construction workload across most of the UK is positive.

Tender prices and construction costs have continued to rise partly due to increased shortages of labour and materials in many regions. Tender prices are expected to continue to rise in at least the short-term.

The shift from single to two stage tendering or negotiated contracts as reported in previous regional inflation reports continues, although there may be a turning point for larger value projects ahead of us. Contractors are generally more selective about which opportunities to pursue, naturally opting for those with less risk and potentially higher margins.

Gleeds’ regional offices report as follows:

The Cambridge market remains buoyant in both the education and residential sectors. In particular, the residential sector continues to grow in East Anglia. Tender pricing is competitive, with preliminaries at around 13%, and the volume of tenders is expected to continue to increase alongside construction costs.

An element of uncertainty exists in the region with continuing masonry shortages and insufficient labour (particularly in the finishing trades) affecting the industry. The number of bankruptcies is reported to have risen across the quarter.

The construction workload is expected to remain stable for the rest of 2015.

In our previous quarterly report, the general outlook for the Eastern region was positive with tender volumes increasing.

The London market is and is expected to remain buoyant to the end of this year and in all probability beyond. There has been a shift away from single stage tendering towards more risk averse two stage tendering over the last 18 months; getting a single stage tender can be difficult unless dealing with a newcomer to the market who wants to establish workload and cash flow over initial profit. We may start to see this change though as contractors consider the time and cost of two stage tendering.

This risk transfer process is looking like a market structural shift and, as predicted in last quarter’s report, we may witness the re-emergence of management contracting arrangements.

The key inflationary drivers are primarily labour, as commodity prices globally, particularly for steel and copper, have been falling. This is especially true of the supply chain, and main contractors are having to be selective over which contracts (and which clients) to tender to in order to ensure they keep their suppliers on board. Bricks, façade and cladding systems, concrete and M&E equipment are identified as being in short supply, while larger scale projects are reported to have a restricted supply chain, particularly for curtain walling and structural frames.

In our previous quarterly report, we advised of labour insufficiencies in the region. A shift from single stage towards two stage tendering was becoming apparent and the London market remained buoyant.
The construction market in the Midlands is extremely competitive with a number of new projects underway. Payment terms are improving for subcontractors in order to secure their commitment to a project.

However, construction costs are continuing to rise. The ongoing shortages in labour and certain materials are compounding this. Larger projects in particular are having difficulty sourcing enough supply of curtain walling and structural frames, while brick supplies are now on extended order. This is affecting projects being able to finish on programme. Glass and glazing continues to be largely imported.

Due to the restricted labour capacity and increasing workload, there is a risk that price inflation will be such that projects become financially unviable due to outstripped values.

Furthermore, some contractor frameworks are reported to be not working well. Clients are beginning to suggest that contractors selected from frameworks are not offering value for money through their subsequent tenders.

In our previous quarterly report, we reported that the labour and material shortages were ongoing and beginning to impact on competitive tender pricing.

The construction industry in Leeds remains busy; major contractors have full order books with two stage tendering the norm on larger projects due to specialist subcontractor unwillingness to compete unless with a ‘preferred’ contractor. Public sector capital spending appears to be delayed (not stopped) with projects being put ‘on hold’ due to ongoing budgetary review. Bricks and glass remain in short supply.

Newcastle reports sufficient levels of high quality labour and no material shortages for the quarter. The construction workload is expected to continue to increase alongside construction costs and volume of tenders. With the increasing number and size of construction projects locally, most contractors are preferring to go for the two stage or negotiated procurement routes and declining invitations for single stage design and build tenders. Larger scale new build and conversion projects have also been on the increase over the past year, whilst contractor’s overheads and profit levels have remained at very competitive levels.

In our previous quarterly report, we commented that the North East remained extremely competitive and that tenders were increasing. However, the labour and brick shortages were causing instability.

Research from the latest edition of the Northern Ireland Construction Bulletin notes that in Q1 2015:

- The total volume of construction output increased by 2.0% compared with the previous quarter, representing the fourth consecutive quarter of growth. This is 18.0% higher than the same quarter in 2014.

Looking at movement in sector activity:

- New work increased by 4.7%
- Repair and maintenance decreased by 4.9%
- Other work decreased by 1.6%
- Housing increased by 11.9%

- Infrastructure decreased by 8.5%

In Q2 2015, construction output was at 104.8% of the average output reported for 2011, an increase of 2.0% from the previous quarter. In the same quarter, overall construction output in Great Britain was at 103.5% of the average output for 2011.

In our previous quarterly report, we considered that output had increased by 6.5% over the quarter.
The construction industry within the North West region is improving with a lot more sites currently under development. However, this has led to a shortage of main contractors who are willing to enter into a single stage tender procedure, especially on the higher value, more complex or risky projects. Tenders are not very competitive and whilst overheads and profit seem to remain at around 6%, the subcontract tenders look to be increasing tender costs, budgets are severely under pressure and value engineering is the norm. Two stage design and build procurement routes are favoured due to the retention of risk by the employer up to contract.

It is reported that the supply and quality of labour is sufficient to meet the increasing workload. No material shortages are reported for Liverpool but Manchester is still experiencing brick and plasterboard shortages.

In our previous quarterly report, we reported that projects previously placed on hold were beginning to develop, while shortages were also beginning to impact on cost. Workload insecurity was bringing an element of uncertainty.

In Scotland, workload for the construction industry is increasing and is expected to remain stable for the near future. However, limited resources in the labour market are impacting the capacity for growth; both the quantity and quality of labour are reported as being insufficient to meet requirements. Contractors are often declining the opportunity to tender for construction projects as they have largely secured their workload for the next twelve months. Tenders are also being affected by estimating workload where requests for extension of time are commonplace. Work has even been declined on this basis.

Going into the fourth quarter of 2015, the construction industry remains competitive. The gap between supply and demand is still evident in Scotland, as it is in a number of regions across the UK. Added to this, there is an increasing trend towards contractors dropping out the tender process due to lack of resources. In the past year, there has been a notable shift towards migrant labourers on construction sites, but it is still unclear as to how sustainable this is going forward. Masonry shortages remain across the region.

In our previous quarterly report, we reported a return of confidence to the Scottish market in general with particular growth in the residential sector. However, uncertainty still existed over the sustainability of labour sources and projects still awaiting the ‘green light’ to progress.
Regional Reports

Richard Hine
Reporting on the South East Region

In the South East region, there is a steady supply of work and contracting companies are busy. There is a lack of medium size contracting organisations as some contractors have gone out of the market following company mergers and takeovers and subsequent restructuring. There is a demand for offices as some office space has recently been converted into residential properties. There is a strong demand for housing and some large residential schemes planned for the area.

While tender pricing remains competitive, the shortages in masonry and labour are continuing to impact on the industry.

In our previous quarterly report, we reported that the buoyancy to the construction industry in the South East was creating pressure on contractors and sub-contractors, particularly in light of ongoing skills and resource shortages in the region.

Matthew Quirk
Reporting on the South West Region

The South West market remains competitive overall. Whilst there is variance in the outlook of the region from contractors, consultants, and clients, the majority indicate a steady or growing market. Contractors have reported an increase in tenders being won via existing relationships with clients rather than competitive procurement. That said, contractors are no longer in the position they were at the start of the year when they could dictate procurement routes, i.e. two-stage tendering.

Contractors appointed under a two-stage approach report that they are struggling to obtain three competitive sub-contractor tender returns for their brickwork packages. Increases to the lead in time for structural steel packages has been reported, as have time increases to the mechanical services and concrete frame packages. With market demand increasing, the lack of labour in certain trades is likely to result in further increased lead-in times. Inflationary price rises are currently more a result of labour cost increases rather than material increases.

Looking slightly further ahead, the Hinckley Point project could have a profound effect on resources, both labour and materials. With uncertainty surrounding the project and its programme the exact impact is difficult to measure and therefore pricing projects with long durations is currently challenging.

In our previous quarterly report, we reported the continuation of an increasing workload across the region alongside increased contractor selectivity. It was noted that contractors were struggling to obtain multiple competitive quotes during the second stage tender process.
Regional Reports

Construction output is looking to increase quite considerably over the next two to three years within local South Wales market. Specifically, areas such as Cardiff and Swansea have potential for large numbers of schemes to commence across commercial, educational and industrial sectors.

Large projects seem to be moving forward with the new financial investment from overseas, and projects of this nature will draw large labour forces, which could put pressure on local projects and effect tender prices as companies look to secure labour from further afield.

The local market continues to suffer from lack of a sufficient number of large contractors able to fulfil local workload and a number of key contractors are reaching saturation.

Furthermore, the lack of supplier stocks and the risk involved in holding large stocks (particularly for doors and bricks) is leading to longer order/procurement periods.

The local market is likely to be affected by a number of large project developments in the pipeline, including Hinckley Point, M4 Relief Road, and a number of projects within the Cardiff City Centre re-generation programme.

In our previous quarterly report, we reported a longer order period being imposed by the shortage of bricks and doors. The industry in Wales was reported as being competitive to the extent that there may be insufficient numbers of contractors able to fulfil the workload requirement.
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BCIS Quarterly Briefing
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RICS UK Commercial Market Survey

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Key
ONS: Office for National Statistics
HM: Her Majesty’s Treasury
BCIS: Building Cost Information Service
RICS: Royal Institute of Chartered Surveyors

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