February 7th 2014
Michael Hanley
Economist

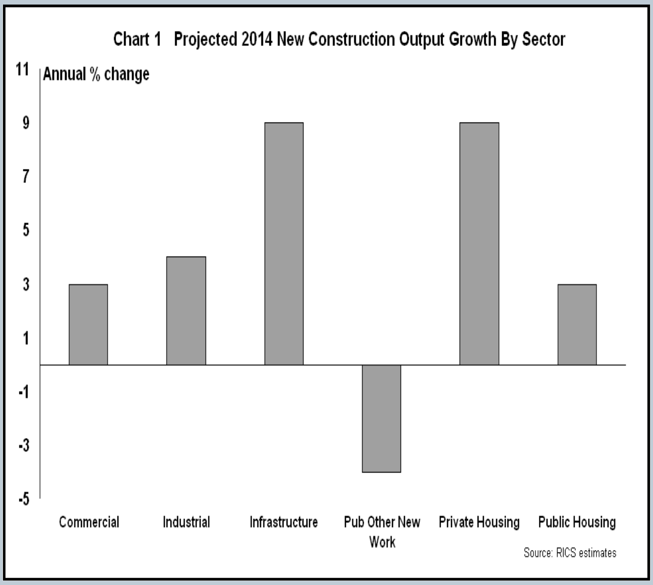
The Outlook for the Construction Sector

- Growth of 4% expected over 2014
- Private housing and infrastructure to be key drivers
- Skills shortages beginning to emerge

The construction sector is beginning to show some signs of recovery five years after the onset of the financial crisis and one of the deepest recessions in the country's history. The recently revised official data suggests that construction output grew by 2.6% in both Q2 and Q3 2013 and that output had grown by around 1% during the first three quarters relative to the same period a year earlier. The improving trend is also visible in traditional lead indicators of the official data, with the RICS Construction Market Survey showing rising workloads amongst quantity surveyors around the country.

The housing sector was the main driver of rising activity early in 2013, but more timely data currently show growth being recorded across the majority of construction sub-sectors as the year progressed. Even so, housing and infrastructure are likely to remain the primary force behind rising activity in 2014 and growth is likely to be more robust this year than looked likely even a few quarters ago. Both sectors have benefited from government policies with the former having gained from the Help to Buy scheme, while the latter has received support from, amongst other policy initiatives, the raising of the Highways Agency's budget in the Autumn Statement 2012. This is contributing to the recent output growth and ongoing road construction will continue to support activity in 2014.

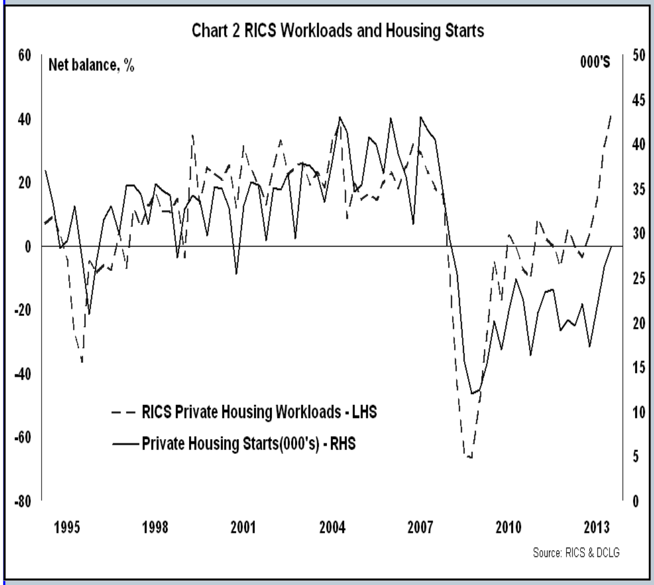
All things considered, we expect to see growth in headline construction output of approximately 4% in 2014. This will be the highest growth since 2010, a year in which the public sector contributed substantially to the industry's performance. The private sector-led expansion that we expect to see this year represents a potentially more sustainable path of growth for the industry going forward given the pressure on government budgets. However, output in the sector still remains around 12% below it's pre-recession peak. We expect total housing output growth in the region of 8% over the year, but we also anticipate the majority of the other sectors making a positive contribution to growth (see chart 1).



Help to Buy Boosts Housing Output

New orders for private housing were 34% higher in the first three quarters of 2013 relative to the same period of 2012 and housing starts have reflected this, up 23% over the same period. RICS leading indicators suggest little evidence that this rapid pace of growth will slow in 2014 (see chart 2).

Activity in the sector is being buoyed both by specific policy measures and by the broader economic recovery which has boosted confidence and employment. The Funding for Lending Scheme (FLS) has had a substantial effect since its introduction in mid-2012, contributing to a marked lowering of mortgage rates. The abandonment of the household lending component of this policy from January this year will reduce some of the support for the housing sector but we believe the momentum is already in place to carry the sector strongly through the year and there is still support from other policy measures. The Help to Buy scheme, for example, remains in operation and is helping to alleviate the deposit requirements that some would-be buyers find difficult to meet. Aside from the relatively cheap funding on offer through the FLS, the wholesale funding costs available to banks also became more accommodative in 2013 and have been conducive to the lower mortgage rates that have been on offer.



Nowhere is the buoyancy in housing demand more clearly seen than in the RICS Residential Market Survey, where the pace of increase in new buyer enquiries has surpassed the growth in new instructions to sell since early this year. This increase in demand should keep house prices rising through next year, which will provide house builders with the confidence they need to keep increasing their output without the fear of eroding profit margins.

The demand-supply imbalance in the housing market is countrywide with increases in new buyer enquiries outpacing increases in new instructions to sell across all of the 12 areas of the UK that we monitor since September 2013. This should lead to a widespread increase in housing construction and the RICS Construction Market Survey has reported rising private housing workloads across all regions of the UK for five consecutive quarters.

On top of the increase in housing starts witnessed this year, we expect a further increase in 2014 to a total of around 150,000 starts across England. In addition to the activity already ongoing in the sector, we expect this to result in private housing output growth of 9% in 2014.

Private housing R&M has been soft over the last few years due to pressure on real incomes. The sector often feeds off growth in sales activity, with a significant proportion of the work undertaken in the sector being carried out on newly acquired properties. On the back of the stronger sales market and the improving economic and employment conditions that we expect to see in 2014, we envisage moderate growth in the region of 3% in this sub-sector over the year.

Public housing orders have been increasing since late 2011 and orders in the third quarter of 2013 were the strongest for two decades with output some 2.5% higher than the same period of 2012. Growth in the sector will come largely from the Affordable Housing Programme (AHP) component. With the current AHP approaching its end there will be a drive for completion of projects by the end of March 2015 because of the funding structure of the programme. As a result, we expect to see output growth in the region of 2% in the sector over the course of 2014. Significantly, the RICS Construction Market Survey has recently recorded the first two consecutive quarters of rising workloads in the sector since the end of 2007.

Public housing repair and maintenance work tends to be quite practical and essential work that cannot be postponed for very long periods. The latest data for 2013 show output having decreased by 3.5% and the sector has been on a broadly downward trend of late. Given the relative necessity of a lot of the work in the sector, output is likely to be at very worst flat over the course of 2014 but we foresee a modest increase in output of 1% in 2014.

Infrastructure

Work has now begun on all stations involved in the Crossrail program and work will peak over the coming 18 months. Both this project, (Europe's largest infrastructure project) and Network Rail's continued

RICS UK (press office)
T +44 (0) 20 7695 1682
sthornton@rics.org

RICS Europe
T+32 2 733 1019
ricseurope@rics.org

RICS Americas
T +1 212 847 7400
ricsamericas@rics.org

RICS Asia Pacific
T +852 2537 7117
ricsasiapacific@rics.org

RICS Oceania
T +61 2 92162333
info@rics.org.au

RICS Middle East & Africa
T +971 4 375 3074
sluthria@rics.org

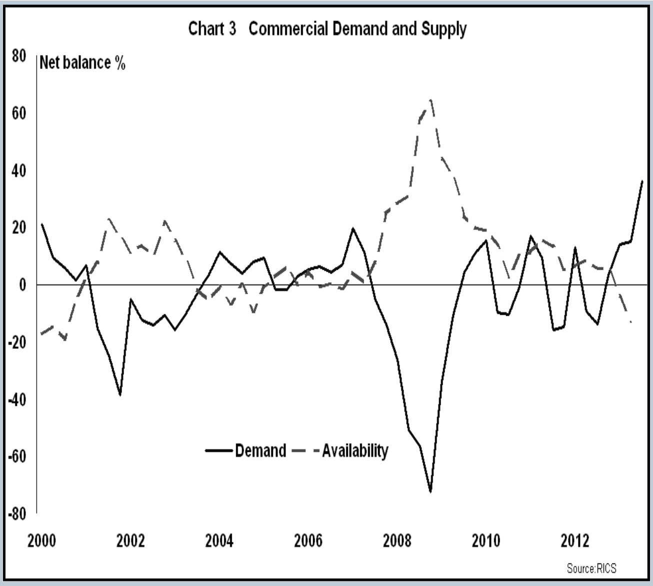
programme of upgrades will keep the rail sub-sector active throughout the year. The roads sub-sector will also remain buoyant and should be a good source of employment for the industry with £1.9bn of planned Department for Transport expenditure supporting activity.

Output in the infrastructure sector remains very high by historical standards, reaching record levels in both 2010 and 2011 before falling 11% in 2012. During the first 3 quarters of 2013 output had grown by 3.7% relative to 2012 and the momentum in the sector shows little signs of easing. Industry members continue to report rising workloads and strong confidence that these workloads will be sustained through this year. Indeed, quantity surveyors have reported rising workloads every quarter since Q3 2012 and Glenigan data suggests that civil engineering project starts in Q4 2013 were up 40% compared to a year earlier. We envisage this sector performing strongly this year and foresee output growth of around 9% even though the governments hopes of encouraging greater private participation in the sector have yet to be realised to any significant extent.

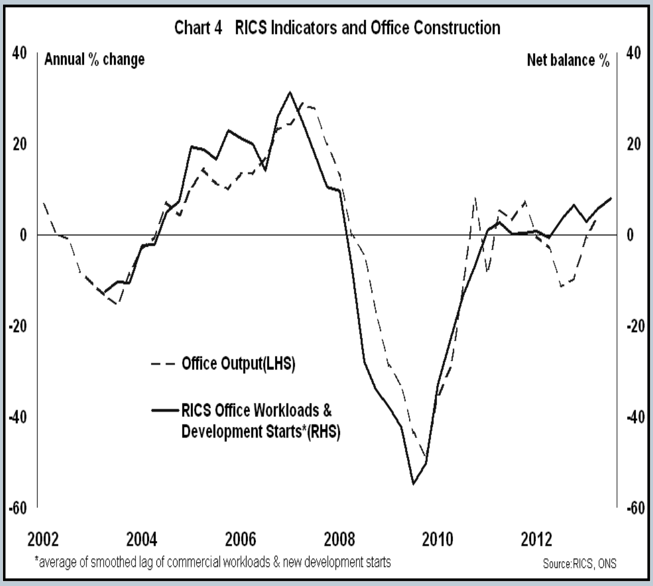
Commercial

Revisions to the official data show commercial construction on a broadly upward trend since the fourth quarter of 2012. Office construction has been the main driver of growth so far with activity in the retail and entertainment sub-sectors recently beginning to contribute on the back of the greater economic stability and consumer confidence that built up over 2013. The scale of the recent revisions in the sector highlight what leading indicators of activity had suggested; that the sector was seeing more activity than the official data were recording. The RICS net balance of workloads in the sector had previously been on a broadly stable trend but has been rising steadily since Q4 2012.

While orders in the sector were marginally down in quarterly terms in Q3, they are up by over 20% in yearly terms following a similar gain in Q2. Indeed, conditions in the occupier market have improved recently with the stronger economic prospects driving demand for commercial space while some of the excess stock that had built up during the recession years is now beginning to decrease (see chart 3).



Investor interest in the prime office sector has been strong over recent years. This is partly because of its perceived safe haven status with London in particular receiving large investment inflows because of its relatively large and liquid market. Despite growing investor interest in the office sector outside of London in recent quarters, construction activity is likely to remain mostly focused in the capital in 2014. While Deloitte's London Office Crane Survey reports over 9.7m sq ft of office space currently under construction in the capital alone (as of Q4 2013), construction activity across the five other main regional cities (including Birmingham, Glasgow, Edinburgh, Leeds and Manchester) remains near a long term low at just 840,000 sq ft.



Feedback from RICS members suggesting rising workloads and growing numbers of development starts (see chart 4) leads us to expect the office

RICS UK (press office)
T +44 (0) 20 7695 1682
sthornton@rics.org

RICS Europe
T+32 2 733 1019
ricseurope@rics.org

RICS Americas
T +1 212 847 7400
ricsamericas@rics.org

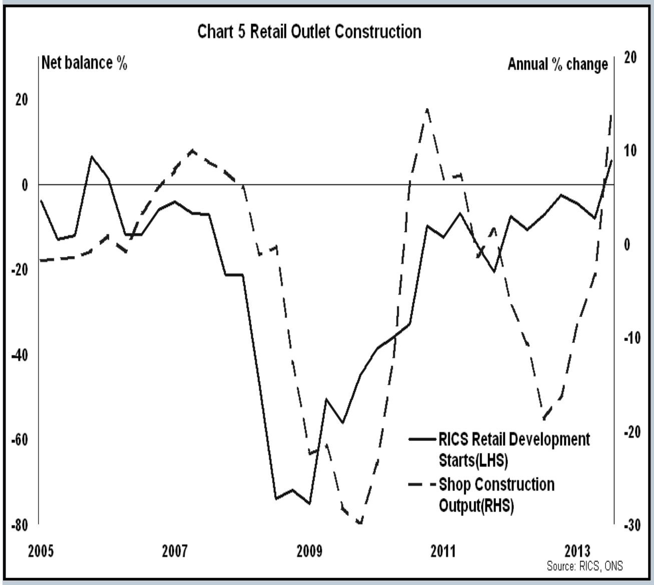
RICS Asia Pacific
T +852 2537 7117
ricsasiapacific@rics.org

RICS Oceania
T +61 2 92162333
info@rics.org.au

RICS Middle East & Africa
T +971 4 375 3074
sluthria@rics.org

sector to be one of the more active components of commercial construction output in 2014.

Retail construction was a big casualty of the recession and has been slow to recover with negative real wage growth and poor consumer confidence levels keeping retail spending subdued until very recently. Construction orders in the pipeline for retail space remain low in comparison to the levels of the last decade or so, but the sector is beginning to see some signs of stabilisation on the back of a more optimistic economic outlook for next year and the stronger consumer spending of recent quarters. Output expanded in both Q2 and Q3 2013.



Glenigan data suggests that the underlying value of new retail construction starts in Q4 2013 was twice the level of a year earlier and indeed the RICS Commercial Property Market Survey has reported two consecutive increases in new development starts in the sector over the second half of 2013 (see chart 5). While the activity seen in the sub-sector of late is encouraging, further growth will be very much dependent on a sustained economic recovery and we would expect growth to be moderate at best to begin with.

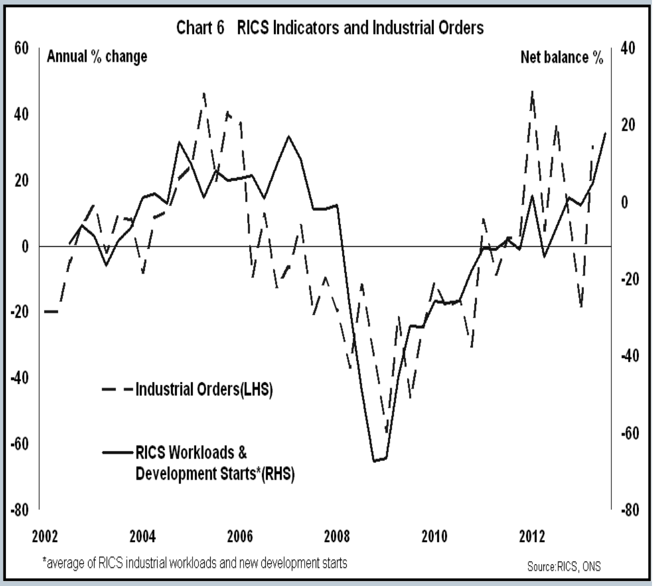
Another of the more promising sub-components of the commercial sector is schools and universities, where orders in Q3 2013 were more than 40% higher than Q3 2012 following strong orders through the first half of 2013. Given that the commercial sector remains the largest construction sub-component, the headline total output figure is very sensitive to changes in commercial development activity and it is encouraging for the industry that the sector looks to be finding its feet.

Before the recent revisions, expectations were that the commercial sector had the potential to again weigh on headline output growth this year. The revisions reinforce the more optimistic outlook for the sector that had been suggested by the RICS Construction Market Survey and we are currently expecting growth in the sector of around 3% over the course of 2014.

Industrial

The most recent data shows industrial construction down by 3.3% over 2013. The sector tends to respond very quickly to economic conditions and output has been very volatile in recent years.

However, employment in the manufacturing sector has been increasing for several quarters recently; the first time this has occurred in many years. Orders for factory construction have increased substantially since late 2011 and while orders for warehouse construction had been decreasing until Q3 this year, the underlying trend was still upwards. Warehouse orders surged to a five year high in Q3 but factory construction is still likely to be the main driver of output growth through 2014.



The positive momentum in the sector is clear from chart 6. Although output in this component can be particularly volatile from quarter to quarter, we expect a moderate expansion over the course of 2014 and envisage output growth in the region of 4%.

RICS UK (press office)
T +44 (0) 20 7695 1682
sthornton@rics.org

RICS Europe
T+32 2 733 1019
ricseurope@rics.org

RICS Americas
T +1 212 847 7400
ricsamericas@rics.org

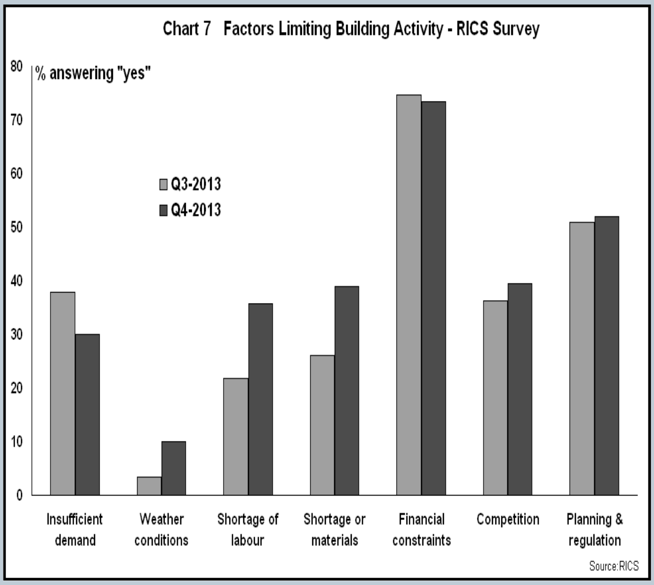
RICS Asia Pacific
T +852 2537 7117
ricsasiapacific@rics.org

RICS Oceania
T +61 2 92162333
info@rics.org.au

RICS Middle East & Africa
T +971 4 375 3074
sluthria@rics.org

Public Other New Work

Public construction activity is continuing to feel the strain of government austerity measures. Orders in recent quarters have stabilised somewhat and the sector will be less of a drag on headline output growth this year than it has been since 2011. However, given continuing pressure on government departmental budgets we foresee a further decline in output of around 4% over 2014.



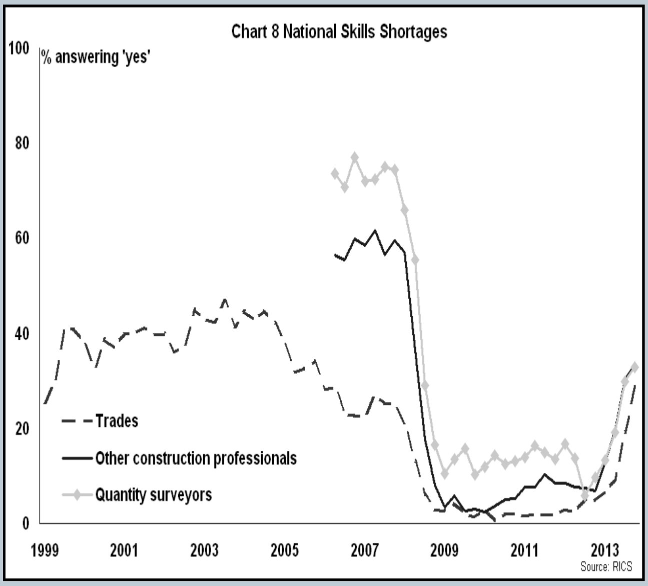
Challenges

Financial constraints have consistently been cited as the main factor limiting construction activity in the RICS Construction Market Survey over the last two years. This is unsurprising given that lending to the sector contracted both in absolute terms and relative to other sectors of the economy during the recession. While lending to the construction sector decreased by nearly 40% between early 2009 and the end of 2012, lending across all sectors of the economy decreased by an average of only 5%. This is partly because the construction sector is dominated by SME's (BIS research suggests that over 99% of contracting firms are SME) which tend to have lower levels of capital/ fixed assets to act as collateral against loans. Therefore banks consider lending to the sector riskier than lending to other parts of the economy.

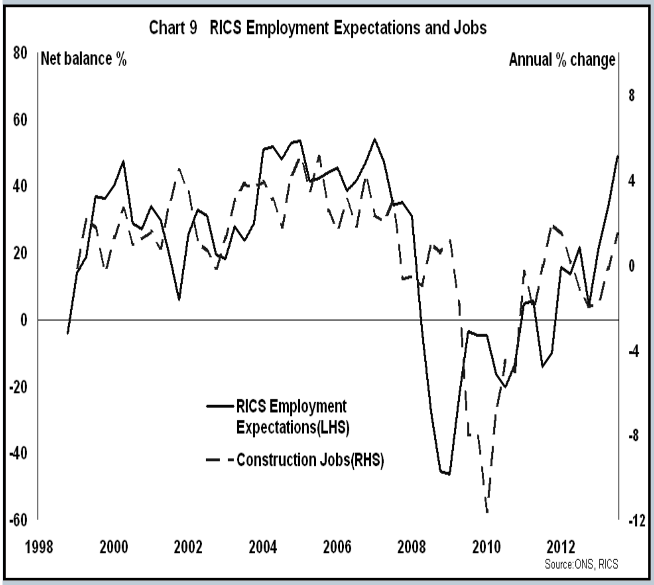
The problems that industry members have been reporting with insufficient demand are becoming less severe as the economic recovery strengthens and this feeds through to consumer and business confidence. Even over the course of 2013 there was a substantial reduction in the proportion of respondents reporting low demand as a constraint on activity; while 70% of respondents cited demand issues as a limiting factor in Q1, only 30% were still experiencing problems in Q4. An easing of funding conditions as banks regain confidence in the industry will help to enable demand for construction activities and this should naturally accompany an improving macroeconomic environment.

Planning and regulatory issues are consistently reported as a constraint on activity by around 50% of respondents to the RICS Construction Market Survey. Anecdotal evidence suggests that these appear to be a significant structural impediment to UK construction that needs to be addressed.

The recession period resulted in a substantial number of professionals leaving the industry and skills shortages could pose more of a challenge as the year progresses and the sector strengthens. Even the modest expansion in activity over 2013 resulted in increasing reports of skills shortages across a range of disciplines (see chart 8).The recent growth in housing construction appears to have highlighted particular shortages in certain professions with almost half of the respondents to the Q4 RICS Construction Market Survey reporting shortages of bricklayers and over 20% of respondents noticing shortages in all of the other main trades.



Traditional lead indicators of changes in construction employment suggest that further jobs growth is imminent over the coming quarters (see chart 9). The RICS Employment Expectations net balance reached a series high in Q4 and respondents now expect jobs growth of almost 3% in the industry over the coming 12 months.



A growing number of construction professionals are beginning to encounter shortages of building materials but this is perhaps more likely to be due to the very recent acceleration in activity as opposed to any significant lack of capacity and we do not expect this to be a substantial constraint on activity in the near term.

Conclusion

As the economic recovery gains traction through 2014, we expect the construction sector to follow suit with output growth in the region of 4% over the year. The infrastructure and housing sectors will continue to expand and the commercial sector will contribute more to growth as the year progresses. The industrial sector is set for a better year with factory construction pushing growth. Skills shortages may become more problematic as growth accelerates but financial constraints currently remain the key issue limiting construction activity.

RICS UK（press office）
T +44（0） 20 7695 1682
sthornton@rics.org

RICS Europe
T+32 2 733 1019
ricseurope@rics.org

RICS Americas
T +1 212 847 7400
ricsamericas@rics.org

RICS Asia Pacific
T +852 2537 7117
ricsasiapacific@rics.org

RICS Oceania
T +61 2 92162333
info@rics.org.au

RICS Middle East & Africa
T +971 4 375 3074
sluthria@rics.org