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Review of Scottish Business Surveys

Overall

A wider sense of despondency was evident amongst business surveys commenting on the third quarter results, with the exception of the oil and gas sector, the emphasis was on a weakening economy, with weak consumer demand, output down in construction, declining export activity and more concerns as to activity over the year ahead. Both the latest Scottish Chambers Business (Q3) and Lloyds TSB Business Monitor survey (Q3 to August) commented on the 'stagnating' Scottish economy. The Bank of Scotland PMI (September data) noted a decline in private sector output, reflecting a declining trend in new work, a reduction in backlogs and accelerating input price inflation due to rising fuel and commodity prices. The CBI data for Q3 similarly noted a decline in both new orders and output. Declining trends in export orders and Eurozone uncertainties were seen as contributing to a decline in orders was reported by Scottish Engineering (Q3).

Scottish Chambers' of Commerce Business Survey (SCBS) respondents reported that the continuing weakness in the Scottish economy was more widespread in Q3 than in the first half of 2012 as the trends in demand in manufacturing and in tourism weakened. The outturn in all sectors in Q3 was weaker than expected and weak in all main sectors. Business sentiment weakened in all main sectors, furthermore in all sectors the main trends in activity remain weak, reinforcing the sense of weak, stagnating demand and continuing negative growth. The percentage of respondents in all sectors expecting an improvement in demand in Q4 is limited; the majority anticipate either no change or a weakening in demand, suggesting few, if any signs of an improvement in the Scottish economy over the short term. In the SCBS report for the second quarter the findings concerned the sense of a slowdown in economic activity across our major markets together with the adverse effects of on-going reorganisation and cutbacks in the UK public services influencing both consumer and business sentiment and activity in Scotland and in the rest of the United Kingdom. At the end of the third quarter they reported more signs of a slowdown and a wider sense of an economy stagnating with weak and inadequate performance.

Similarly the latest Lloyds TSB Scotland Business Monitor (June- August 2012) showed an economy continuing to stagnate although stressed that there were no signs of a return to deep recession. The Scottish Engineering Quarterly Review reported that uncertainties as to the Eurozone economy was now impacting on the order intake of Scottish engineering firms although noted the encouraging figures from the Oil and Gas sectors, but reported large firms were now less confident.

Oil and gas services

Globally the outlook for the oil and gas sector in 2013 remains positive, notwithstanding continuing political and economic uncertainties. The increasing global interest and potential of shale reserves is beginning to influence both national energy policies and the global oil market. The techniques applied to the development of shale gas are now being applied to shale oil fields and related areas. In the US this has led to rapid production and shale and Canadian oil sands could, according to some industry figures, help make the US self-sufficient in oil by 2020 – 2025. Both oil companies and a number of countries in Europe, Asia and South America are exploring the shale gas and oil potential. In the medium term an increased supply of lower cost gas could 'crowd out' the development of renewables and or nuclear energy generation and affect the supply of LNG from conventional gas reserves with impacts on the cost of gas in some countries. However, the conditions for the successful exploitation of shale gas may limit its development, and environmental concerns have to be overcome, but there is much to suggest the development of shale gas will revolutionise the global gas industry, possibly leading to differing models of development across the globe and will impact on the energy policies and prices (IHS CERA 2012). Estimates of the economic and employment opportunities from shale gas in the UK vary considerably, and it is uncertain whether the current ban on drilling for shale gas in the UK will be lifted by the end of 2012.

Notwithstanding the drive towards renewable energy generation hydrocarbons will continue to be the dominant source of energy, providing over 1/3 of EU energy needs in 2030 and almost all energy used in transportation. The past eighteen months has witnessed a number of changes to the UK's tax regime. The Budget in 2011 increased the Supplementary Charge, but post budget changes improved Ring Fence Expenditure Supplements. The 2012 Budget and post budget changes included: increased allowance for small fields and for large deep water activities, the introduction of a brownfield and large shallow gas

allowance and initiated consultation on measures to provide decommissioning certainty, all of which heralded a more positive environment.

The latest Aberdeen & Grampian Chamber's oil and gas survey (October), the Oil & Gas UK quarterly index and Deloitte's review of drilling activity all indicated rising confidence in the sector reflecting more positive tax changes, continuing demand, high oil prices and potential developments in the UKCS, Eastern Mediterranean and Africa.

However, as Oil & Gas UK noted that whilst the signs of a recovery in new field approvals and merger and acquisition activity indicate investor confidence is returning following the announcement of measures by the Government aimed at boosting activity, but it is important to see the rising confidence in the context of low levels of exploration activity in 2011 and more changes are arguably necessary to boost long term drilling activity.

Private sector

The Bank of Scotland PMI paints a picture of a continuing slowdown in the Scottish economy; momentum had picked up slightly during June 2012 but then growth started to falter again in July and August and turned down in September. Increased concerns as to trends in exports, weak consumer demand, and rising cost pressures were evident in surveys covering the third quarter.

Production

The Lloyds TSB Scotland Business Monitor reported that the overall net balance of turnover for production firms in the three months to end August this year was -2%; slightly down on the +4% of the previous quarter and the 0% of the same quarter one year ago.

Manufacturing

According to SCBS manufacturing respondents business confidence weakened significantly in quarter three with a net balance of 22% of firms reporting reduced confidence levels. Business optimism remains weaker than a year ago, reflecting concerns as to the continuing Euro zone weaknesses, a theme echoed in the latest Scottish Engineering's Quarterly Review, but less so in the latest CBI report.

During the three months to the end of September, the trend in total new orders declined by more than had been expected for a net balance of SCBS firms. Respondents are also more cautious as to the trends in orders in the fourth quarter. Scottish Engineering reported a downward trend in the total order intake for the first time since the Q4 2011 although electronics, oil & gas and machine shops performed more strongly, but there were marked differences both in the outcome and expectations between small, medium and large firms. Encouragingly forecasts for Q4 2012 anticipate an improvement although the turnaround is limited to small and medium size firms as large firms expect orders to remain negative. The trend in export orders remained negative (for all sizes of company). Engineering respondents are anticipating that exports will continue to decline but the decline will slow.

Average capacity utilisation improved although was down on the same quarter of 2011. The underlying weaknesses in demand remain evident with more than half of firms reporting working below optimum levels.

Turnover is expected to decline for a small net balance of firms (respondents in the previous quarter had forecast a rise). The net trend in profitability is also weaker than in the second quarter with a net balance expecting a fall in profits.

Although remaining weak, the trends in investment in plant/machinery improved slightly during quarter three for a net balance of SCBS manufacturing firms with around 60% expecting no overall change. New investment was again mainly directed towards replacement or to improve efficiency. Scottish Engineering firms reported positive trends in investments.

A net balance of SCBS firms reported a decline in total employment levels although around two thirds continued to report no change to overall levels. Slightly fewer than 12% of firms increased pay during the three months to September and the average increase was 3.5%. 43% reported seeking to recruit staff, and difficulties remained limited. Scottish Engineering respondents reported and expect a rise in overall employment levels and continued to report skill shortage in relation to project engineers, design engineers, IT specialists, technicians, welders and CNC machinists. Scottish Engineering also reported deep concerns regarding the ageing workforce.

Construction

Business confidence weakened further in the third quarter for SCBS respondents; however, although the rate of decline worsened compared to Q2 it was less severe when compared to Q3 2012. The latest data available from the Scottish Building Federation's Scottish Construction Monitor (SCM) is for Q2 2012 and indicates that their business optimism index declined further and now stands at -40.

SCBS Orders continued to slow at much the same rate as in the previous quarter and further declines are forecast for Q4. With very few new contracts evident construction firms continue to rely on repair and maintenance work. The decline in public sector orders steepened slightly. More than three-quarters, compared to 70% in the previous survey, reported working below capacity. Cash flow trends continued to decline for SCBS firms. Turnover and profitability are still expected to be weak over the next 12 months together with continued pressure on margins. Average capacity used declined marginally from 75.7% to 74.6% although was broadly in line with the Q3 2011 level. The downward trend in employment continued in Q3 with few SCBS firms reporting a rise. Once again few recruitment difficulties were evident. Average pay increases fell from 2.3% in Q2 to 2.0%.

Markit/CIPS noted the UK construction sector 'remained rooted in contraction territory' in its report for September 2012. The survey found that an upturn in civil engineering was offset by further declines in house building and commercial activity.

In Q2 2012 the Scottish Building Federation asked a series of questions to their members regarding the submission of PQQs for public procurement. The results indicated that most firms with a turnover of less than £2 million did not submit any PQQ's for public procurement during the past three years. Many of the smaller firms indicated that they were dissuaded from participating in public procurement due to prohibitively high associated costs. The survey found that the average construction firm had to submit 36 pre-qualification questionnaires for every successfully secured public contract, indicating an average success rate of 3%.

Logistics and wholesale

Data from the SCBS business survey showed that business optimism amongst Scottish wholesale firms continued to decline with slightly fewer than half of firms reporting a decline in business confidence. Business confidence however, was less depressed compared to one year ago. The downward trend in sales was broadly in line with expectations from the previous survey; a net balance expect the decline to continue, though ease, in the final quarter of 2012. More than 80% of SCBS wholesalers continued to report increased pressures from transport costs. Pay settlements were cited as a pressure for 16% of firms. More than 60% of firms expect to increase prices over the next three months. Cash flow trends weakened although concerns over turnover and profitability remained high. Once again most firms reported no change to investment plans; nevertheless there was a decline. Wholesale respondents on balance, reported an unexpected net increase in overall employment levels during the third quarter of 2012 although a net balance expected to shed staff in Q4. A third sought to recruit staff; largely for replacement. The average pay increase in Q3 was 2.2% compared to 1.8% in Q2.

Retail Distribution

Weak sales trends were consistently reported over the summer months, with discounting, multiple retailers planning to reduce the numbers of stores and a spate of retail closures (see PwC Report) being widely reported; and the high street vacancy rate of 14.5% being marginally higher than at the end of 2011. The widely reported low levels of business confidence continued to ease marginally in the third quarter of 2012 for SCBS firms, and although the net balance remains negative it is marginally better compared to Q3 2011.

The SCBS retail survey base is primarily small/medium independent outlets and only 11% reported and only 8% expect increased sales, as continuing concerns over consumer confidence remain evident in Q3. Cost pressures remain historically high, although those concerned with increasing suppliers costs eased from 61% to 56%. Transport costs and utility costs also continued to be of particular concern. Pressures on margins remain widespread with over half expecting declining profitability and turnover over the next year. Labour market activity continued to decline with only 8% reporting and 10% expecting an increase in

overall employment levels. Recruitment problems also eased. Only 12% of firms reported increasing pay, and the average increase was 3.4%.

The Scottish Retail Consortium reported sales up by 1% in September, but this was again driven by rising food sales, overall sales still remain lower than a year ago. Whilst the Scottish Retail Consortium had reported a 1.2% increase in June sales, Scottish sales were reported as 'dire' in August when they fell by 0.9% (compared with August 2011 which saw a decline of 0.7%). After accounting for inflation, the Olympic month recorded a real terms decline in total sales of 2%, suggesting little, if any, 'bounce' in retail sales as a result of the Olympics.

Tourism

The latest available Scottish Hotel Occupancy Surveys (July 2012) reported bed and room occupancy fractionally lower than for the comparable months in 2011, 2010, 2009 and 2008 – with only Aberdeen & Grampian, Fife and Scottish Borders reporting improvements in both room and bed occupancy compared to a year earlier. April and June figures were better than the preceding years.

Weak consumer demand continues to affect the sector with insolvency studies reporting higher numbers of restaurants and restaurants at risk and higher levels of hotels for sale.

Business confidence among SCBS tourism respondents declined during the third quarter of 2012 although optimism levels were not as depressed compared to Q3 2011. More than half of hotels reported a fall in visitors during the three months to the end of September; and more than half anticipate a further decline in the final quarter of 2012. The trend was much worse than had been forecast by respondents from the previous survey. Average occupancy rose from 64% to 68% although was down on the same quarters of 2011 and 2010. During the three months to the end of September 2012, trends in bar/restaurant trade and for conference/ function facilities continued to decline. A net balance of firms had expected to increase daily room rates in the three months to the end of September but the pattern was one of continued discounts. These 'special offers' seem set to continue with a net balance of 23% expecting to decrease room rates in Q4 2012. More than three-quarters reported that the lack of tourist demand remained the primary business constraint. Poor transport infrastructure, high fuel costs and weak marketing of the area also remained a concern to hotels. Fewer than 20% of hotels sought to recruit staff and employment trends, as forecast, continued to decline. A net balance of 29% of tourism respondents 29% employment levels to ease in Q4 2012.

Outlook

The latest data from the Lloyds TSB England Regional PMI suggests Scottish performance remains weak compared to most English regions and to the UK and Wales, and at a 21 month low compared to a two month low for the UK. At the UK level there are signs of weaknesses ahead with rising input price inflation, weak consumer demand and continuing pressures on margins. Increasing activity and investment are set to continue in the oil and gas sector and this continues to impact positively both in manufacturing and in the Aberdeen and Aberdeenshire economies, but generally weak domestic and export demand continues to undercut these effects.

The latest Aberdeen Chamber oil and gas survey, Oil and Gas UK and A Deloitte report all highlight the shortage of skills in the oil and gas sector, and this is echoed in the latest Scottish Engineering's Quarterly Index. Concerns as to shortages of skilled staff coupled with an ageing workforce suggest that firms may be hoarding labour and this might contribute to the current changing relationship between employment and productivity (see the Labour Market Section).

At the end of the third quarter there are more signs of a slowdown in the Scottish economy and a wider sense of an economy stagnating with weak and inadequate performance. Increasingly business organizations are calling for changes to UK government policies to drive the economy, but there are few signs of any change in national policy and the current age of austerity seems likely to continue.

Cliff Lockyer/Eleanor Malloy
October 2012

Current trends in Scottish Business are regularly reported by a number of business surveys. This report draws on:

1. Aberdeen & Grampian Chamber of Commerce Survey no 17 November 2012;
2. The Confederation of British Industries Scottish Industrial Trends Survey for Q2 and Q3 2012;
3. IHS CERA. IHS Upstream Operating Costs Index (2012);
4. HIS Unconventional Gas. Transforming the Global Gas Industry(2012);
5. Lloyds TSB Business Monitor Issue no. 58 and 59;
6. Markit/CIPS UK Construction PMI for July, August and September 2012;
7. Scottish Engineering's Quarterly Review Q2 and Q3 2012;
8. The Bank of Scotland Markit Economics Regional Monthly Purchasing Managers' Indices for July, August and September 2012;
9. Lloyds TSB England Regional PMI for August and September 2012;
10. The Scottish Retail Consortium's KPMG Monthly Scottish Retail Sales Monitors July, August and September 2012.