TRADE CREDIT

Construction Update April 2022

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INTRODUCTION

Just when we are starting to recover from the pandemic, Russia's war with Ukraine will deal a £90bn blow to the UK economy driven by a worsening cost of living crunch according to the Centre for Economics and Business Research (CEBR). Soaring energy prices as a result of the war has contributed to high inflation, alongside pending tax rises will heap more pressure on households and businesses.

Britain's economy suffered the worst recession in 100 years as the initial wave of Covid-19 and late initial lockdown caused a sudden stop in activity across the country. UK GDP plunged by almost 20% in the second quarter of 2020 and by 9.4% for the year as a whole – the worst performance in the G7. The economy has since grown at the fastest rate in the group of wealthy nations, partly because of the snapback from a bigger fall and returned to pre-Covid levels in December 2021. However, other G7 nations are further above their pre-pandemic levels, including the US and France. Given the current pending price pressures, GDP is expected to expand by only 3.6% in 2022.

Inflation has risen to the highest rate since 1992 in the fallout from Covid-19, with Russia's invasion of Ukraine threatening to add to the problem. Disruption to global supply chains, shortages of workers and materials have led to the cost of living soaring. Annual inflation rate in the UK increased to 6.2% in February of 2022 from 5.5% in January and above market forecasts of 5.9%. It is the highest inflation rate since March of 1992, as rising cost of energy and food continues to squeeze the living standards. Biggest price increases came from transport (11.5% vs 11.3% in January); furniture and household equipment (9.1% vs 8.4%); clothing and footwear (8.9% vs 6.3%); housing and utilities (7.2% vs 7.1%) namely electricity, gas and other fuels.

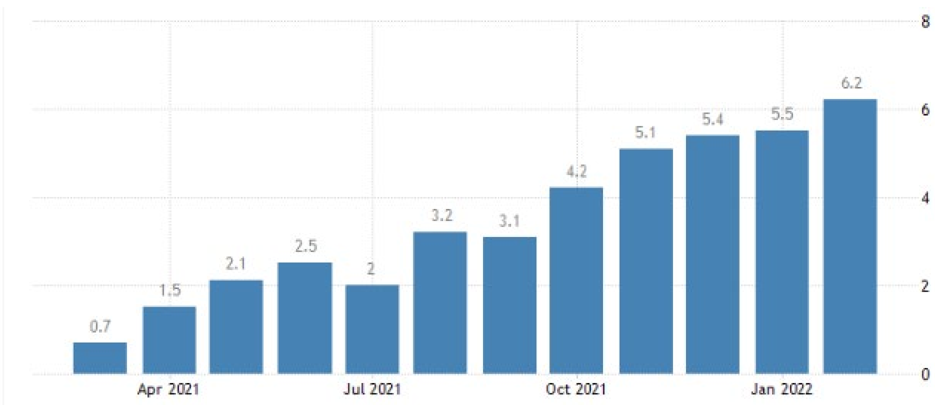

Fig 1: Inflation rate per months (ONS)

CONSTRUCTION SECTOR

The Construction sector has seen strong demand since lockdown was eased and the Covid-19 Omicron variant had subsided. However, rising materials, labour costs and supply shortages continue to hold back growth, though order books remain strong. Many businesses have already begun to see further increases in the price of energy and the continuing Russia/Ukraine war has seen shortages of certain goods.

We are starting to see that rising material and labour costs had caused delays to some projects as customers/investors wait for costs to come down or make some projects unviable. Lead times for many materials continue to be lengthy, but some report placing orders early and buying larger quantities of materials in order to limit the effect of shortages – easier for large Companies. Construction growth is expected to remain positive this year, with demand supported by public sector infrastructure spending, strong housebuilding activity and plans to reconfigure office and commercial space. A mild winter has helped to maintain higher than average levels of construction during the first two months of the year.

Supply challenges continue to affect certain products including bricks, air blocks, roof tiles, steel lintels, cable trays and trunking, gas boilers and some electrical products, particularly those using semi-conductors and microchips. Price inflation, largely caused by a shortage of raw materials, rising energy, freight and labour costs seem to be a greater concern than availability. Price increases of 5-10% have been announced by many manufacturers so far this year, and energy-intensive products have increased by as much as 20%.

UK CONSTRUCTION PMI

With increasing inflationary pressures now evident, will the post-Covid revival continue? The latest figures from the Office of National Statistics (ONS) show construction output during 2021 increased by +12.7% compared with 2020. Although we must remember that activity in 2020 was severely compromised by Covid restrictions, resulting in a record -14.9% fall in output that year.

The IHS Markit/CIPS UK Construction PMI registered 59.1 in February 2022, up from 56.3 in January to signal the strongest rise in output since mid-2021. Building companies have reported the strongest rise in output amid stronger client confidence and work on new projects commencing. Construction companies continue to report widespread supply constraints and rapidly increasing input costs.

Fig 2: Construction PMI (IHS Markit, CIPS)

CONSTRUCTION INSOLVENCIES

Corporate insolvencies decreased by 3.2% in February 2022 to a total of 1,515 compared to January's total of 1,565 and increased by 121.2% compared to February 2021's figure of 685. They were also 12.6% higher than in February 2020 (1,346).

The monthly fall in corporate insolvencies is being driven by a reduction in all types of corporate insolvency processes, with the exception of administrations, whose numbers increased to a 15-month high. Consumer spending has declined, and consumer confidence is low as people worry about the economy and their own financial position, with inflation now a real problem for businesses and households. This situation is unlikely to improve anytime soon given the impact the war in Ukraine will have on energy costs.

In Construction, February 2022 the recorded number of administrations was at its highest level since the start of the pandemic. In total, there were 31 administrations in the construction industry in February 2022, the biggest total in nearly two years.

The rise in insolvencies in Construction could be due to the end of the furlough scheme as well as the end of tax breaks such as VAT payments as well as external factors already mentioned. Construction was the largest recipient by volume of applications for Covid loans and the second largest by value. The additional loans have increased interest and debt repayments for many, adding to cashflow concerns. Add in rising material costs and inflation, companies struggling for cash only need one or two jobs to go badly before they potentially run out of money.

Some notable Construction Insolvencies this year include:

- **Midas Group** - COVID and delays to contracts eventually meant Midas ran out of money and was unable to pay its subcontractors. At the time of administration, Midas owed £22m to creditors.
- **Wildgoose Construction Limited** (a 125-year-old company) went in to Administration owing nearly £9m to over 700 unsecured creditors. They had been making losses even before the pandemic with tough trading conditions, supply chain issues, shortages of raw material eventually caused its demise.
- **P.D.R. Construction Limited** reported a turnover of £83m, up from £70m the prior year suffered due to the pandemic and cost price issues.
- **Kaicer** provided roofing, cladding and glazing solutions failed owing subcontractors and suppliers around £4.2m. The company owed HMRC around £850k for 18 months of unpaid taxes.
- **Caledonian Modular** had a turnover of £45.3m in its most recent published accounts but suffered from project delays.
- **Roadbridge UK** failed in March 2022 citing cashflow issues and had contracts on the HS2 project understood to have been worth up to £60m.

CONCLUSION

With inflation set to increase, material price pressures to continue and interest rates recently increased the Construction sector will be under immense pressure this year. This is on top of the other external pressures including reverse VAT charge and the red diesel tax. Construction material prices rose in 11 of the 12 months of 2021 (BEIS) with contractors paying on average a fifth more for products and components at the end of the year than they did at the start.

The rising inflation effects in construction are a problem anyway but coupled with the widespread use of fixed-price contracts, this year could be more problematic than ever. Over 83% of businesses in the construction sector are SMEs, helping to keep the sector going. For the sector to survive this year main contractors need to talk to their suppliers and work together in the face of rising cost pressures.

Material price pressures are not expected to fall this year, as supply chain problems, high production costs, distribution problems and high demand for materials continue to hit the industry. Construction companies will also have to contend with continued high timber prices.

Timber prices are not expected to fall significantly from recent highs, but improved supply chains and more stable growth in residential construction should contain price pressures. Timber Trade Federation said timber prices were being affected mainly by labour and logistics costs going up and added that energy prices do not have that much of an impact on timber as it has a low energy cost.

Contractors are facing serious difficulties after prices of certain construction products have soared by a fifth already this year and although only c1% of building products to the UK come from Russia, Ukraine or Belarus, there will knock-on effects from the conflict. There are many pressures facing the industry this year and careful monitoring and controlled pricing will be key in 2022 and beyond.

At Nexus we continue to seek and evaluate Construction companies on a case-by-case basis. We continue to proactively approach Companies for the latest Management accounts and information.

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