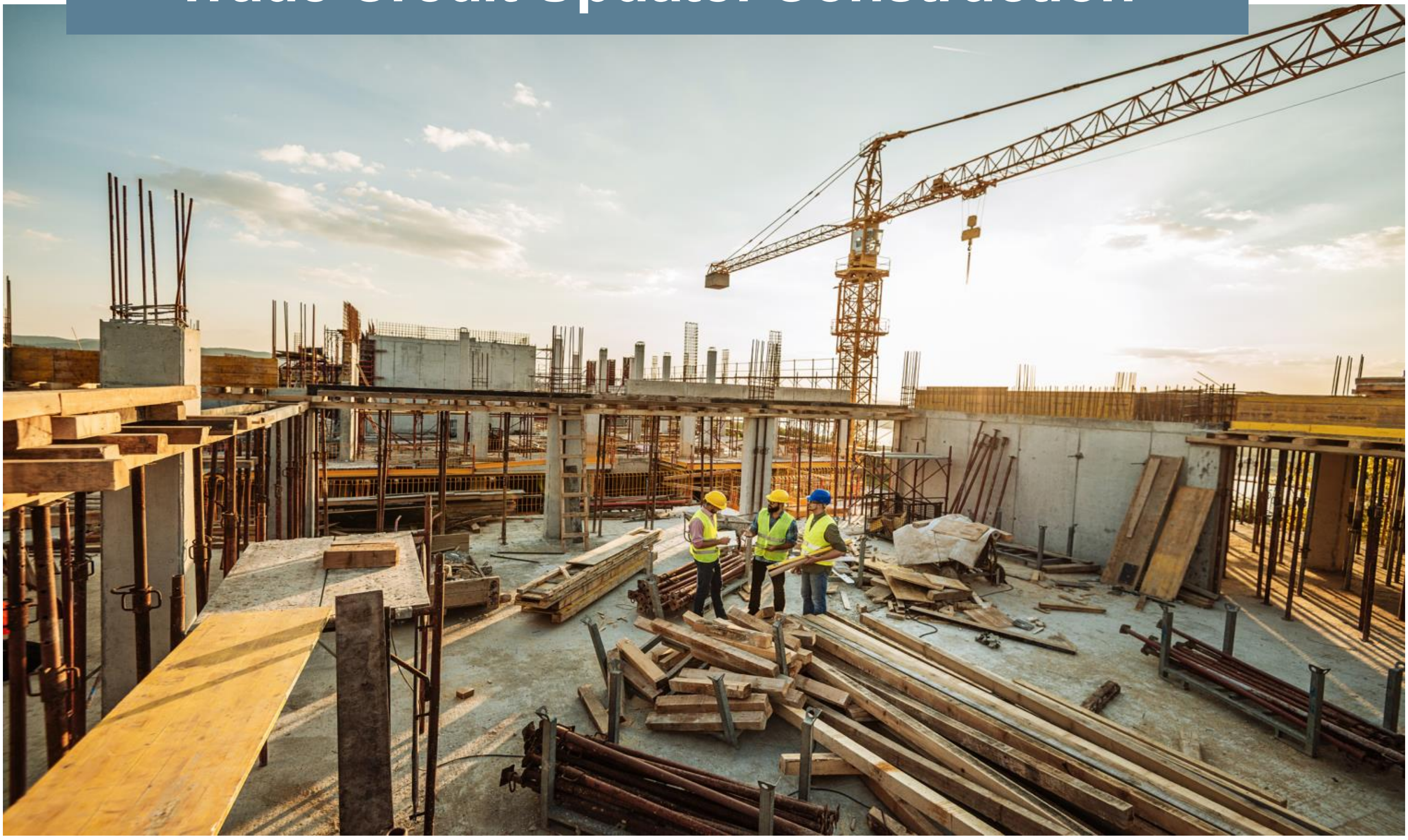
Trade Credit Update: Construction

Q4 2019



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OUTPUT – PURCHASING MANAGERS' INDEX

2019 was a challenging year for construction and the final quarter was no different.

Political and economic uncertainty continued with the Christmas general election and output maintained its declining trend. The Purchasing Managers' Index (PMI) for December 2019 came in at 44.4, down from 45.3 in November. Any score below 50 indicates a reduction in output. Our primary concern with these numbers is that we have seen considerable reductions in activity across all sub sectors. According to the PMI data, commercial work fell for the twelfth consecutive month as clients postponed spending decisions ahead of the general election. The PMI data also stated that house building activity dropped for the seventh month running in December. The silver lining is that housing market conditions remain strong and we're seeing early signs of increased activity in the sector.

Civil engineering is the worst performing sector and the PMI data states that output has fallen at the fastest rate since March 2009. The decline can be pointed towards the delay to key infrastructure projects such as Crossrail, Heathrow expansion and HS2. Crossrail Phase 2 can only commence when Phase 1 is complete. It is likely the completion date for Phase 1 will be in at the back end of 2021. The Heathrow expansion continues to be plagued by confusion and the final decision continues to be delayed.

HS2 is the key issue. The budget is £56bn, but it is now estimated that the total cost could rise to £106bn. This is due to engineering costs, poor ground conditions and underestimating the cost of running 225mph trains. It is therefore no surprise that after years of austerity there are talks of changing the scope to reduce costs. There have even been calls to completely scrap the project. This would have a detrimental effect on the contractors whose turnover relies heavily on work from HS2.

The official findings of the Oakervee report are due to be released in the next couple of months. This will hopefully provide some further clarity so that the government can make a final decision. Considering the project has not even started, it is likely the cost will end up being well above the current £106bn figure. Businesses may not be directly impacted by these project delays, but they still affect the investment confidence in the United Kingdom. Projects like HS2 can also unlock development land so the indirect impact can be huge.

CURRENT TRENDS

Contractors citing 'project delays' has been a reccurring theme in 2019 and the knock on impact on cashflow has resulted in a number of high-profile failures.

Secondly, anecdotal evidence from meetings with contractors is that pricing has become "more aggressive" and in some cases "suicidal". We have heard of several examples where contracts have been won at a 50% discount. This is clearly not sustainable. Another key issue that keeps being mentioned is the ongoing skills shortage. The industry is suffering from an ageing workforce and it is failing to attract new young talent. This skills shortage delays contracts, stumps growth and ultimately increases costs.

Delayed payments and extended terms remain a key headache for the industry. We therefore welcome the new 'Late payment bill' that is being proposed by Lord Mendelsohn. The bill proposes a statutory limit of 30-days payment for all invoices, banning clients from charging suppliers a fee in exchange for prompt payment and banning firms from charging to be on preferred supplier lists.

INSOLVENCY DATA

The Q4 2019 (October-December) England & Wales insolvency statistics reported the highest level of underlying insolvencies since 2013.

There were 17,196 company insolvencies in 2019 which represented a 6.8% increase on 2018. The highest number of new underlying company insolvencies was in the construction industry and this sector also saw the largest increase in underlying insolvency volumes compared with the 12 months ending Q3 2019.

Latest figures published by the ABI state that trade credit insurers have helped UK firms cope with record levels of bad debts. The value of the average claim made in 2019 increased by 200%, to just over £67,000. (This figure was heavily influenced by the collapse of Thomas Cook).

Here are some of the notable failures in Construction:

- **Clugston Construction –** Loss making energy from waste contracts in Kent and Deeside resulted in administration. The projects were incorrectly priced which resulted in them booking huge increases in labor and productivity costs. Clugston reported revenue of £175m and they boasted a cash balance of £30m in their latest set of accounts.
- **Shaylor Group** – The latest figures available showed healthy profits, low debt and a strong cash balance yet numerous project delays resulted in cash flow difficulties. It is estimated that trade creditors were owed £17m.
- **Simons Group** – Loss making contracts and delays to new projects resulted in cash flow difficulties. The long standing £100m turnover contractor went into administration with the loss of 124 jobs.
- **Bardsley Construction** – The £70m turnover contractor went into administration leaving around 200 people out of a job just days before Christmas. The business had severe cash flow problems due to delays in payments from a number of different projects.
- **Pochin Construction –** Long standing loss making contracts and rising input costs were the key issues which pushed them into administration. The construction arm posted a loss of £6m on revenue of £50.5m in the last set of accounts. They owed £98m to creditors before they failed.

Interestingly, the above businesses were all well established, run by experienced management and produced relatively strong accounts. This shows that early identification of the stressess the business' were experiencing is key and helps to highlight the importance of credit insurance and the additional due dilligence that comes with it.

CONCLUSIONS

The Conservative Party's resounding general election win has certainly stabilised the government and brought some confidence back into the United Kingdom.

We are still expecting the economic and political landscape to remain uncertain as the Brexit negotiations continue in the transition period. We will likely see delays to capital-intensive investment decisions in 2020, which will result in further project delays. We've been surprised by the speed at which seemingly strong businesses have run out of cash and ultimately failed.

With the challenging market conditions set to continue we expect construction insolvencies to remain high throughout 2020. This is why new and existing credit limits need to be supported by up-to-date management accounts, project details and borrowing facilities. With this intense dialogue between all parties we can continue to ensure that cover is maintained wherever possible and any early warning signs of distress highlighted at the earliest possible opportunity.