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MARKET INSIGHT: UK Construction

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Xenia's Market Insight reports are designed to work alongside a credit insurance programme. The purpose of this report is to provide you with objective and practical information that will help to advance your understanding of the issues and how they might impact your business.

We welcome your thoughts and questions on the issues covered. Please email us on info@xeniabroking.com should you require any further advice or have questions about this report.

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Introduction

Despite some optimism gained following a recent announcement from the S&P Global construction index, the sentiment within this realm remains uncertain, especially with the stream of insolvencies we are seeing. It is expected that the sector will experience weaker growth in the short-to-mid-term as concerns about major challenges such as cost inflation, interest rate rises, falling inward investment levels and access to skills and labour intensify. Uncertainty is something the sector has had to deal with for some time, but its continuance will undermine investment confidence and affect the ability of supply chains to trade efficiently, which given the current circumstances will only compound matters. It is hoped that we have seen the worst of recent challenges and the road to recovery, albeit a long one, has commenced. There are some signs and indicators that this indeed is the case, but after the magnitude of recent challenges, we need to remain as vigilant as possible. Although growth is at a low ebb and insolvencies remain high, we have so far avoided the major crisis that some predicted.

Key observations

A worsening global business outlook, supply chain disruption and a trend of high-profile business failures, especially in the construction sector, means more businesses than ever are under pressure. Some are concerned about how these circumstances will impact the survival of their suppliers or B2B customers too. There is no doubt 2023 will continue to serve up further challenge for businesses, with the UK economy showing no signs of letting up. To help with future preparation, we have compiled a list of observations to consider with a view to identifying potential challenges that may impact your business and your strategy in the coming months:

- Continued significant market and economic uncertainty
- Investment delays both domestic and foreign direct
- Input cost inflation
- Shortage of skilled labour and wage inflation
- Legacy or excessively priced fixed contracts
- Increase in new insolvencies particularly SMEs (Small Medium Enterprises)
- Large percentage of Credit Insurance claims heavily linked to construction related fields
- Rise in the number of construction companies in significant financial distress
- Poor payment practices especially within sub-contractor field owing to deteriorating margins
- Strained cash-flow with many firms having to raise their own prices to avoid losing money; a double-edged sword as this may impact competitiveness
- Challenges in other sectors such as Nuclear and Energy from Waste (EfW) impacting contractors
- Corporate CCJs in general have reached alarming new levels and higher than the previous quarter[1]

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[1] https://www.registry-trust.org.uk/stats/q4-and-year-2022-statistics/

UK Construction PMI

The latest PMI (Purchasing Managers Index) data for January 2023 has confirmed that the construction space is now experiencing major challenges. From the increase in the number of insolvencies to the sharpest decline in construction output since May 2020, the drop in the PMI data reflects a concerning, ongoing contraction in the sector. A clear fall in business activity in January highlights the scale of the obstacles the sector faces. We have seen over 30 insolvencies in February - double the number seen in January – indicating the start of increased turbulence coming our way. Construction companies are citing headwinds from lacklustre market conditions, increasing input costs, rising interest rates, poor cash flow and fewer new projects as the main reasons behind the failures. Since the middle of 2021, the trend has been falling with the PMI recorded at 48.4 in the first month of the year.

On the back of the PMI data for the month of January, UK construction companies reported another downturn in business activity during January, largely reflecting weaker client demand and fewer new project starts in recent months. In contrast, business expectations regarding the year ahead rebounded considerably since December 2022, with confidence reaching its highest level for six months. However, there are clear signs that the general economic outlook appeared to have improved, while some cited tentative signs of a turnaround in sales enquiries. Unsurprisingly, many construction outfits indicated a slide in business optimism, with the degree of positive sentiment the most fragile seen since the initial covid crisis. Unease about the business outlook was overwhelmingly attributed to the on-going uncertainties that hover, and a corresponding drop in client spending and cost challenges prevalent across the economy.

Construction insolvency analysis

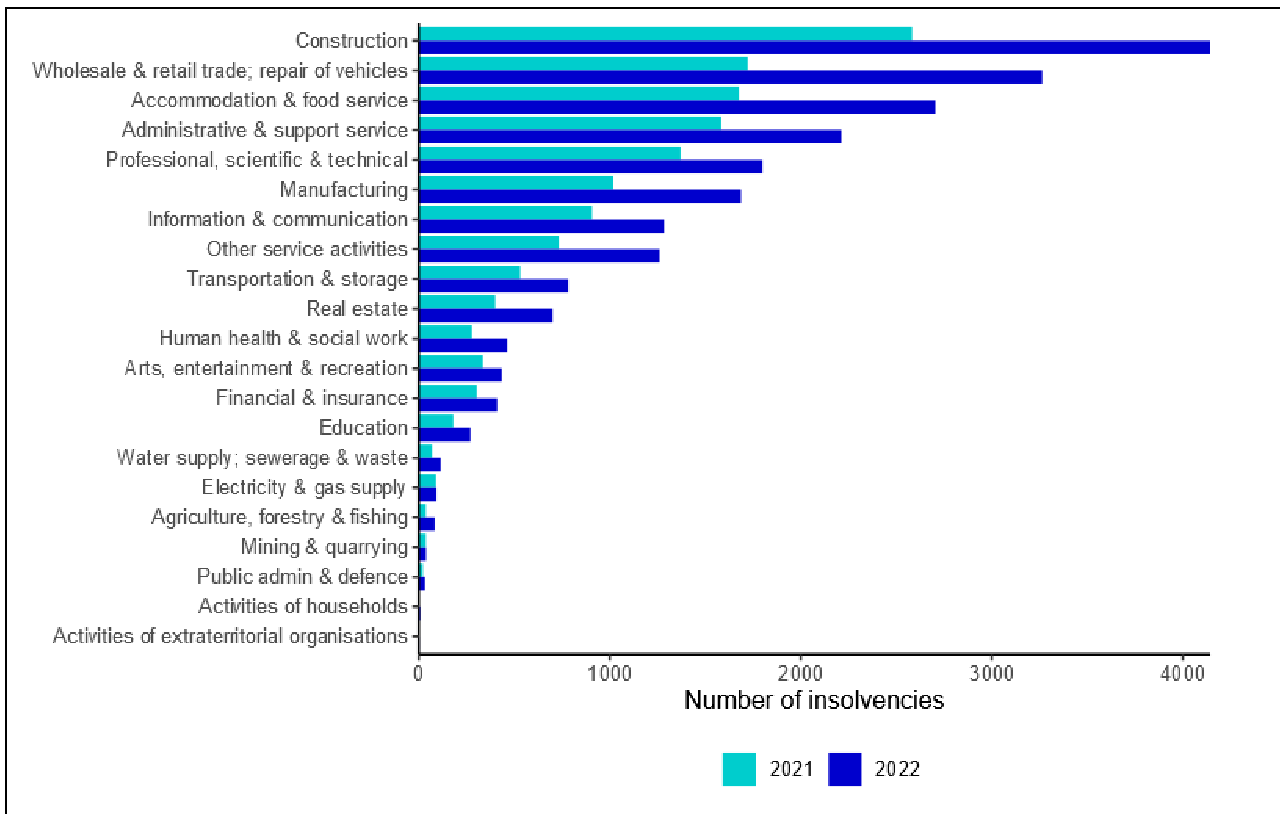
During Q4 2022, there were 5,995 company insolvencies, comprising 4,891 Creditors' Voluntary Liquidations (CVLs), 720 compulsory liquidations, 359 administrations and 25 Company Voluntary Arrangements (CVAs). This was 7% higher than in Q3 2022 and 30% higher than in Q4 2021. The number of CVLs remained close to the highest quarterly level since the start of these records in the 1960s. The number of compulsory liquidations also increased to the highest quarterly number since the start of the pandemic, partly because of an increase in winding-up petitions presented by HMRC and due to a high number of petitions from a single bank.

Company insolvency statistics						
Year	**Total Insolvencies**	**Construction**	**Construction %**	**CVLs**	**Administrations**	**CVAs**
2019	17,164	3220	18.7	12,056	1,813	351
2020	12,632	2061	16.3	9,488	1,527	260
2021	14,059	2582	18.3	12,656	796	115
2022	22,109	4143	18.7	18,321	1,231	111

Total number of registered company insolvencies in 2022 was higher than 2021 and higher than recent pre-pandemic levels. England and Wales, 2019 to 2022.

Construction remained top of the tree in Q4 20222 as is always the case, with 4,143 insolvencies, which was 19% of all cases captured, a staggering one fifth of all insolvencies. For the 12 months to Q3 this number was 3,949 and 3,665 in Q2, so the trend each quarter has improved with less construction insolvencies in Q4 than previous. The construction industry usually has the highest quarterly number of insolvencies of any industrial grouping and this trend is not only continuing it is widening even though all industries saw increased insolvencies in 2022 compared to 2021.

[2] https://www.gov.uk/government/statistics/company-insolvency-statistics-october-to-december-2022/commentary-company-insolvency-statistics-october-to-december-2022



Source: https://www.gov.uk/government/statistics/company-insolvency-statistics-october-to-december-2022/commentary-company-insolvency-statistics-october-to-december-2022

Company insolvencies for March 2023 continued the same trajectory on the back of Q4, January and February 2023, with the number of company insolvencies hitting 2,457, which was 16% higher than the contrasting year, and significantly higher than the number registered pre-pandemic which was around 1,500. This increase compared to the previous month was driven by an increase in the number of compulsory liquidations and CVLs. This trend alone is alarming as it alludes to the intensification of creditor pressure and, in view of the early assumption, UK businesses were more resilient than first thought with other insolvency processes remaining static. There were 288 compulsory liquidations recorded in the month of March, which was more than double the number recorded in March 2022. This significant rise in compulsory liquidations is mainly attributed to an increase in winding-up petitions presented by HMRC. CVLs were 9% higher than in March 2022 with 2,011 registered and 59% higher than March 2020. Numbers of administrations and CVAs remained lower than before the pandemic but were higher than in March 2022.

Another pattern observed by credit insurers is an amplification in late payments which compliments the data above and is corroborated by the latest evidence from credit insurers on claims levels and deep analysis of the ONS data. These highlighted trends all point to an increasing level of financial distress in the market. With those businesses that endured the pandemic now encountering rising inflation, higher energy prices, supply chain disruption and labour shortages, it's possible the tsunami of failures we expected that didn't yet materialise, may now be forming out at sea. It is therefore imperative the appropriate planning and approach are formulated now to counter this disastrous scenario.

Construction insolvencies are once again on the rise, with 30 companies going into administration in February alone, which doubled the total for January 2023. Some key insolvencies seen in February include:

- **Tolent Construction** – (Turnover £198m) £4m loss and a series of financial difficulties such as a number of major loss-making contracts. Tolent was a vital component to the local supply chain and the collapse has had major impact on subcontractors in the area.

- **Metnor Construction** – (Turnover £63m) Significant financial challenges amid contract losses and pressures on profit margins from rising input, labour, and raw material prices alongside supply issues against fixed price contracts.
- **Malin Industrial Concrete Floors** – (Turnover £26m) Significant drop in income down from £38.4m in 2020, cash flow struggles caused by fixed price contracts and delays to several schemes in its pipeline.
- **Outco Surfacing** – (Turnover £16m) Large loss incurred in the 9 months due to challenging market conditions and difficulty in converting agreements into longer term contracts to maintain margin percentages. Only recently had their financial covenants reset following financial challenges.
- **RL Davies & Son** – (Turnover £14m) Accumulated loss making driven by a 12-month overrun of its largest contract and cost increases.
- **SD Samuels** – (Turnover £16m) Loss of a key funder at short notice, amplified by complications on several projects with major loss made in the process on one specific project.

A common theme that is drawn from these insolvencies in addition to the financial challenges already prevalent is a number that occurred in February were linked to fixed price contract issues and the ensuing contractual grievance it caused, impacting cashflow and underlying solvency.

Credit insurance and surety market sentiment

Credit insurance market

Although most of the credit insurance market will continue to write cover where possible, even in such uncertain times, insurers are becoming far more cautious in their underwriting approach to the construction sector. This is due to the current precarious environment, rising claims and the protracted default levels they are seeing. Therefore, it’s no surprise they remain extremely vigilant with the sector.

Broad concerns about acute skills shortages, supply chain pressures and cost inflation were already taking a toll on new business in the sector. Meanwhile, contract pricing and delivery will further increase pressures for construction firms to rely on solid cash flows and prompt payments. Claims are on the increase both in terms of volume and value. Disputes are also rising and questions are being asked whether this trend suggests a prevalence of major cash issues.

This underwriting stance is of course more prevalent in times of uncertainty and the insurers’ cautious focus can be deemed supportive of both the client and the risk given the issues that are currently affecting trade sector-wide. Latest Construction PMI figures reinforce the view that the market is still in contraction with minimal growth seen in the sector. So, there is an air of caution emanating from within the credit insurance market.

Surety market

Over the last year, the surety market has retrenched, some smaller insurers have exited the market or are restricting themselves to existing relationships. Terms have hardened both in terms of rate and security required. The practice of taking partial cash security has increased and risk sharing between insurers has become a prominent feature. The requirement for performance bonds by employers has increased substantially as a protective measure anticipating the effects of increased contractor insolvencies. Wise contractors have latched onto the provision of advance payment bonds to secure upfront funding particularly where deposits are needed to secure material supply.

Key measures & endorsed actions

- Ensure you continue to tighten credit control procedures and pay close attention to sudden changes in payment patterns.
- React swiftly to late payment. It is the most accurate predictor of business failure so don't be tempted to extend agreed terms.
- Become more familiar and aware of your suppliers and their operating base. This everchanging economic landscape and uncertainty can suddenly lead to problems in the supply chain.
- Look to enhance and grow levels of business with new customers steadily and prudently, following thorough assessment of their capability and financial strength.
- Try to be agile and flexible. These are unprecedented times, and many businesses are feeling the pinch but there will be a bounce and it's important to retain the flexibility to benefit from growth when it comes.
- Be wary of customers characterised by excessive levels of discounting. Suppliers must use their judgement on whether such discount initiatives reflect fire sales, which in turn can suggest a poor cash position and ability to pay for goods supplied to them.
- If making advance payments or large deposits to your suppliers, protect your business by requesting an advance payment bond to secure the payment in the event of suppliers' insolvency or non-performance.
- Potentially improve your own cashflow and reduce your credit risk by asking customers for advance payments or deposits, offer them a bond as security for their payment.

Xenia analyst assertion

The future is going to be extremely challenging as tightening on investment and disposable income caused by extensive economic pressures are compounded by fundamental major shifts in behaviour. It is clear that in the short term, where possible, suppliers should certainly be considering strategic decisions to minimise their risk. This can be supported through Credit Insurance as well as curbing any over-reliance on single customers.

The latest trend in insolvencies, payment practices and macro measures clearly show that capital intensive sectors such as construction are suffering, as both business and consumers have taken a more cautious approach and limited exposure in this field. This unfortunately is not positive for the economy as we rely upon construction to act as the life jacket in any recovery. Construction accounts for roughly 17% of all UK businesses and contributes about 6% of the UK economic output - that's £130 billion. The importance and size of this sector cannot be emphasized enough and this is reflected in the sector's employment, with construction jobs accounting for between 5-7% of all jobs in the UK i.e. 2.7m people.

As uncertainty has intensified, more companies within the construction field have become increasingly concerned about both the immediate and long-term impact of leaving the European Union, the investment map for construction infrastructure and the impact of inflation in key areas of cost and pricing. This uncertainty is intensifying every day. Profits margins in construction are under significant pressure, which includes businesses that supply building materials. In this difficult environment, struggling firms are also having to endure inflexible contracts where pricing cannot be renegotiated – this can lead to shrinking profit margins as production costs go up.

However, supply chain bottlenecks are easing as some key indexes show, but this too has its drawbacks as many suppliers purchased significant amounts of stock at high prices when supply was limited. This is driving prices up. These firms will struggle to generate an acceptable yield or break even on these deals as prices fall. Businesses within this sub sector will need to increase the short-term borrowing as a result to meet their working capital needs and, in essence, remain viable.

In summary

The question following this analysis is how should the construction industry respond? Monitoring cash flow and working capital movements, and observing payment performance are essential practices that can be carried out as these will serve and support the credit risk management process along with ensuring contingency plans are in place. Fears of a cash flow squeeze are front of mind for construction businesses as they plan ahead. By strengthening the credit-management wheel supported with a credit insurance programme companies can not only enhance protection over revenues and profitability, but ultimately unlock opportunities and facilitate navigation into new markets. As input prices continue to fluctuate, businesses must realise how to implement and control the effects on profitability as cost management is likely to be a significant challenge this year. There is certainly an expectation that insolvencies across the board will increase, especially for SMEs as they continue to contend with the enduring cost of living crisis, rising energy prices, flat consumer confidence, soaring inflation and the subsequent increasing rates.

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