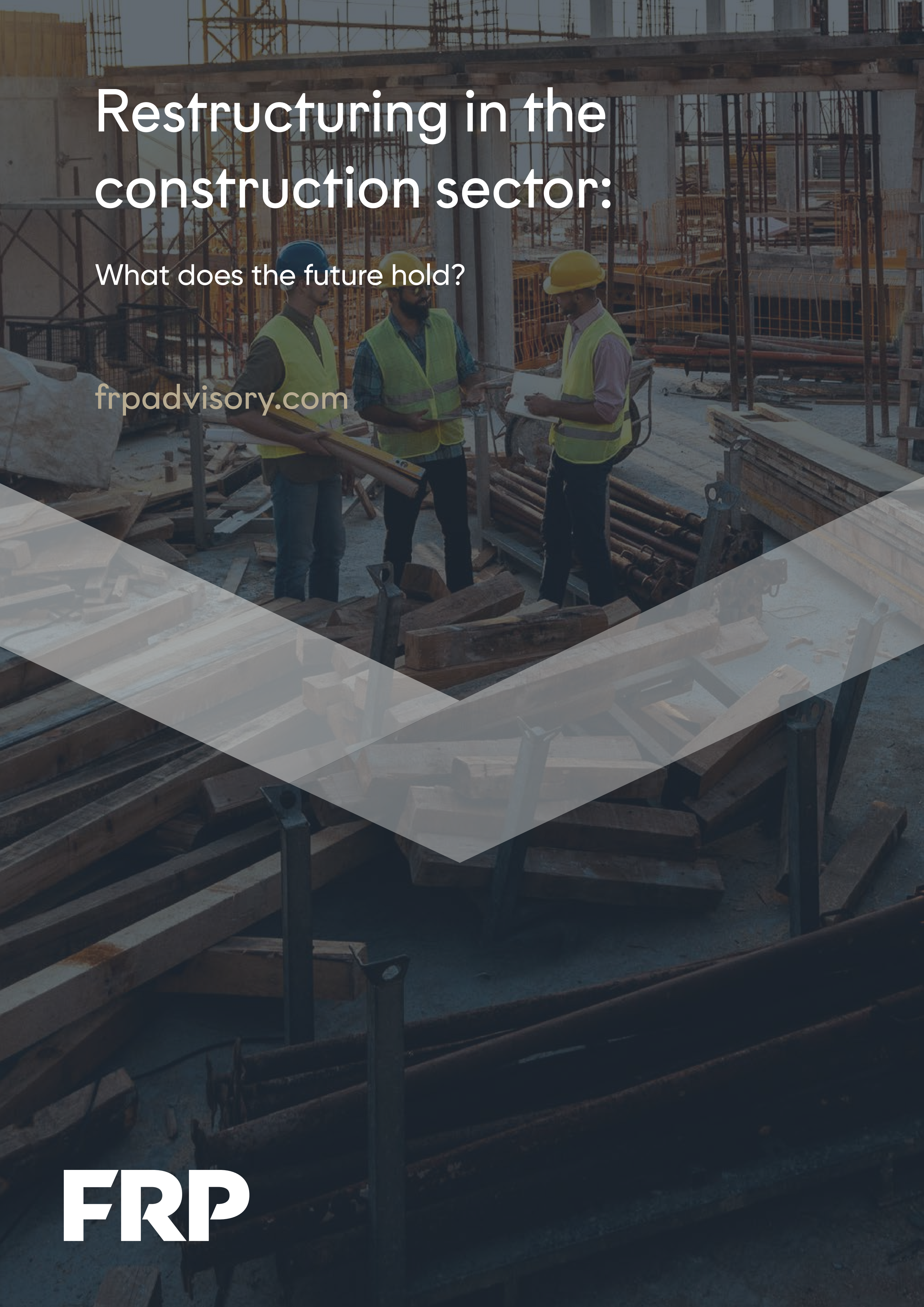

Restructuring in the construction sector:

What does the future hold?

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> Harry Walker
> Corporate Finance

Publication

Restructuring in the construction sector: what does the future hold?

Synopsis

The construction sector has faced significant challenges since the start of the pandemic, and ones that will take some time to resolve.

In addition to initial site closures and the need to adapt to social distancing measures, severe disruption to global supply chains is now driving up the price of raw materials and causing delays. In some cases, steel orders are subject to as much as four months' delay, while some wholesalers are now delivering supplies on allocation.

At the same time, UK homeowners' desires to improve their domestic environments after a series of lockdowns spent at home and a high level of activity in the housing market, are seeing exceptionally high demand across building products manufacturers and domestic building services. This is driving high growth opportunities, whilst also challenging these organisations to keep up with demand, and manage their supply chains to meet customer expectations.

Harry Walker
Partner
Corporate Finance
Leicester
+44 (0)116 303 3253
harry.walker@frpadvisory.com

Martyn Pullin
Partner
Restructuring Advisory
Teesside
+44 (0)164 291 7562
martyn.pullin@frpadvisory.com

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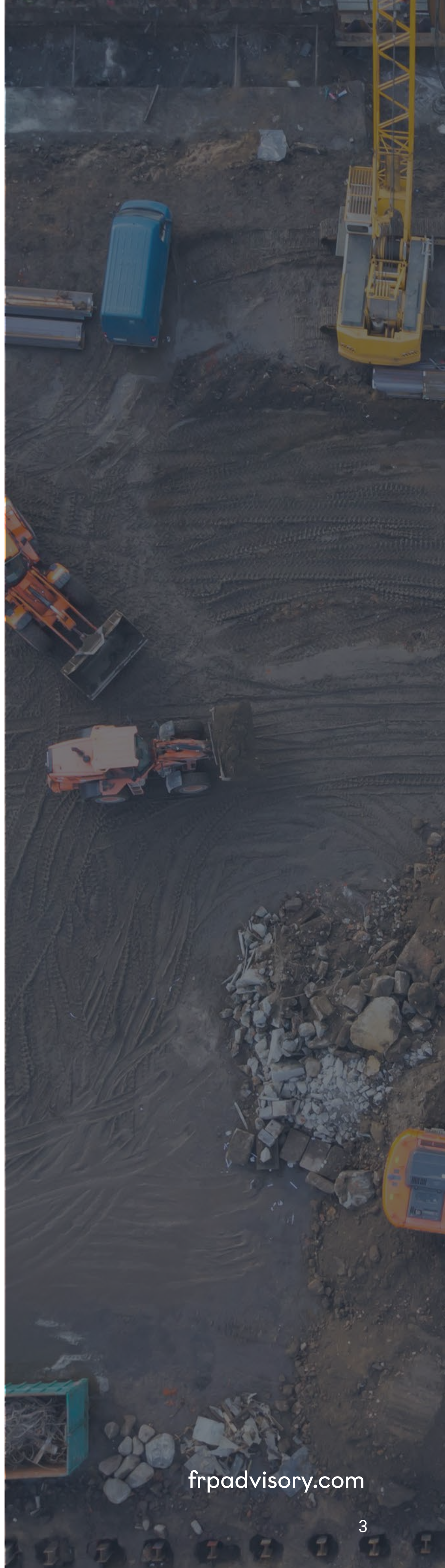

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The supply chain pressures are likely to endure, as a result of the 'double whammy' of a global manufacturing slowdown during the pandemic and the logistical issues created by ongoing trade restrictions. The industry also faces a severe shortage of skilled workers; a problem that pre-existed the pandemic but has been compounded by Brexit and COVID-19.

With average weekly earnings for construction work increasing by almost 14 per cent between April 2020 and April 2021 according to the Office for National Statistics (ONS), we are seeing further pressure being placed on the sector. Here, we explore the specific challenges the construction sector is facing, despite high levels of demand, and the immediate and long-term priorities for construction businesses.

What is the current state of play?

Despite the impact of the pandemic on the UK economy, demand for domestic residential construction has experienced a boom as homeowners seek to improve both their indoor and outdoor living spaces.

On the new build side, and the housing market generally, the Stamp Duty holiday had a big impact, increasing sales activity driven by a desire for more space or better homes following the first COVID-19 lockdown. These high activity levels also contributed to the parallel trend of people looking to improve their homes and build extensions, as opposed to moving.

As a sub-sector of construction, big energy and infrastructure projects, like High Speed Two (HS2) – a high-speed railway network currently under construction between London and Birmingham – are also seeing an increase in demand and a positive funding environment.

A government spending review in 2020 committed £100 billion of capital investment during 2021-22, with over £600 billion of gross public sector investment planned over the next five years as part of its Build Back Better plan for growth*[1], which will support contractors' order books and unlock further private sector investment.

In the industrial building sub-sector, we continue to see a growth in new development fueled by rising rents and capital values with demand currently outstripping supply. This increased demand contrasts markedly with the nervousness surrounding the longterm future of city centers and the future demand for office space.

The big challenge across all areas of construction is around raw material prices. Steel and timber prices have increased considerably since Spring 2020 – with sourcing such supplies proving difficult – which could significantly erode firms' margins; whilst shortages of materials for building products such as resins has had the knock-on effect of increasing manufactured product prices and lengthening lead times.

This is reflected in the latest IHS Markit and Chartered Institute of Procurement & Supply (CIPS) Construction Purchasing Managers' Index, which in August 2021 fell to 55.2, the lowest since February 2021, as growth was weakened by supply chain disruption*[2].

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Notes

*1 Build Back Better our plan for growth. (2021). [online] Available at: https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/968403/PfG_Final_Web_Accessible_Version.pdf.

*2 Reuters (2021). UK construction firms hit again by supply squeeze, prices jump - PMI. Reuters. [online] 6 Sep. Available at: https://www.reuters.com/world/uk/uk-construction-firms-hit-again-by-supply-squeeze-prices-jump-pmi-2021-09-06/ [Accessed 7 Oct. 2021].

*3 Building Products. (2021). Construction industry reports shortage of tradespeople and building materials. [online] Available at: https://buildingproducts.co.uk/construction-industry-reports-shortage-tradespeople-building-materials/ [Accessed 7 Oct. 2021].

*4 Inman, P. (2021). UK economic growth next year will be fastest since 1948, says OBR. [online] the Guardian. Available at: https://www.theguardian.com/uk-news/2021/mar/03/uk-economic-growth-obr-covid-crisis.

How has COVID-19 impacted the sector?

The enduring issues from the COVID crisis are largely around supplies and skills.

The pandemic, combined with Brexit, has greatly impacted the available pool of talent. According to the Office for National Statistics, there has been a 42 per cent fall in the number of EU workers in the UK construction industry since 2017, rising to 54 per cent in London*[3]. The UK currently has low levels of unemployment, and so does not have the capacity in the labour force to fill this void. While a focus on vocational training is important for the longer-term, this arguably won't make an impact soon enough to solve the current skill shortages.

Another challenge for the sector can be seen in the reform of the IR35 regulation introduced in April 2021, seeking to ensure that contractors pay the same National Insurance and tax as employees. This was designed to identify workers employed through their own limited companies, which reduces their tax and National Insurance liabilities, while they are in effect working as an employee. This has seen many one-person service companies having their contracts terminated. Where this represents a de facto pay cut, many are choosing to leave the industry instead, exacerbating the staffing issue.

From an operational perspective, SME contractors in particular may find they are winning work but don't have the staffing or finance to deliver on contracts. While firms can access construction finance facilities to part fund debt and work in progress, it is typically expensive debt. This challenge has been heightened by the VAT reverse charge that came into force in March 2021, compounded by the return of Crown preference. The charge essentially means that sub-contractors require the contractor employing them to pay their VAT directly to HMRC, so no VAT is paid on their invoices, which takes cash out of the working capital cycle.

CBILS and Bounce Back loans have so far masked some of the impact of the reverse charge on smaller sub-contractors, whose forecasting is not as sophisticated as it should be, but overtrading is likely to be an issue.

More positively, those businesses that are able to respond to these challenges in an agile manner have been able to take advantage of high levels of demand for their services and experience record levels of growth.

How is the supply chain coping?

During the pandemic, most building sites were only shut down for one or two weeks at most. The challenge was that some wholesalers, depot suppliers and factories producing materials shut down for four to six weeks – and the supply chain hasn't yet caught up, causing severe repercussions.

Suppliers in the Far East in particular, where many building products are sourced, were interrupted by lockdowns both early in the pandemic around Chinese New Year and on multiple occasions since, while thousands of shipping containers were diverted for critical PPE deliveries. While before the pandemic the price of a container was typically over £2,000, it can now be as much as £14,500. As a result, it's likely that we will see some suppliers seeking to normalise those elevated prices to boost their margins. Together with increases in raw material and energy prices, this has contributed to high price inflation in all building product categories.

At the same time across Europe there is a shortage of lorry drivers, primarily as a result of a lack of new drivers entering the sector due to testing centres being closed for much of 2020, throughout the successive lockdown periods. Many businesses are now offering big signing-on bonuses for haulage drivers, driving up costs amid building supplies becoming harder to move around the country.

Prices often have a habit of staying up when they increase, and so we anticipate that it could be at least two years before price increases start to normalise. Some suppliers are adopting the logical approach of taking on extra warehouse space so they can hold onto more stock. However, as organisations with greater liquidity absorb more stock, that in itself takes capacity out of the market.

For contractors, it's about forecasting further ahead and monitoring working capital tightly. While many firms only review their prices annually, others may be more nimble reviewing it every quarter. A 13-week rolling forecast period will capture most important financial figures including weekly and monthly receipts and payments, plus quarterly payments such at VAT, as well as rent and interest charges.

Critically, contractors need to be brave in passing on their additional costs to clients and developers. Many contractors are not in a position to further strip their margins. Supply issues and price inflation are being experienced across the industry, so clients should be open to discussion. One of the key messages to any business tendering for construction projects is not to fix the price of materials, as this will expose you to substantial risk. Rather, you must look to be nimble and give yourself the flexibility to pass on any cost increases.

What do these challenges mean for the future of the sector?

Currently, there are still relatively low levels of formal restructuring in the sector. However, many firms have accessed all the funding they can from the Bounce Back Loan Scheme, the Coronavirus Business Interruption Loan Scheme and other sources of government support. With the impact of the end of furlough contributing further to the challenges for the sector.

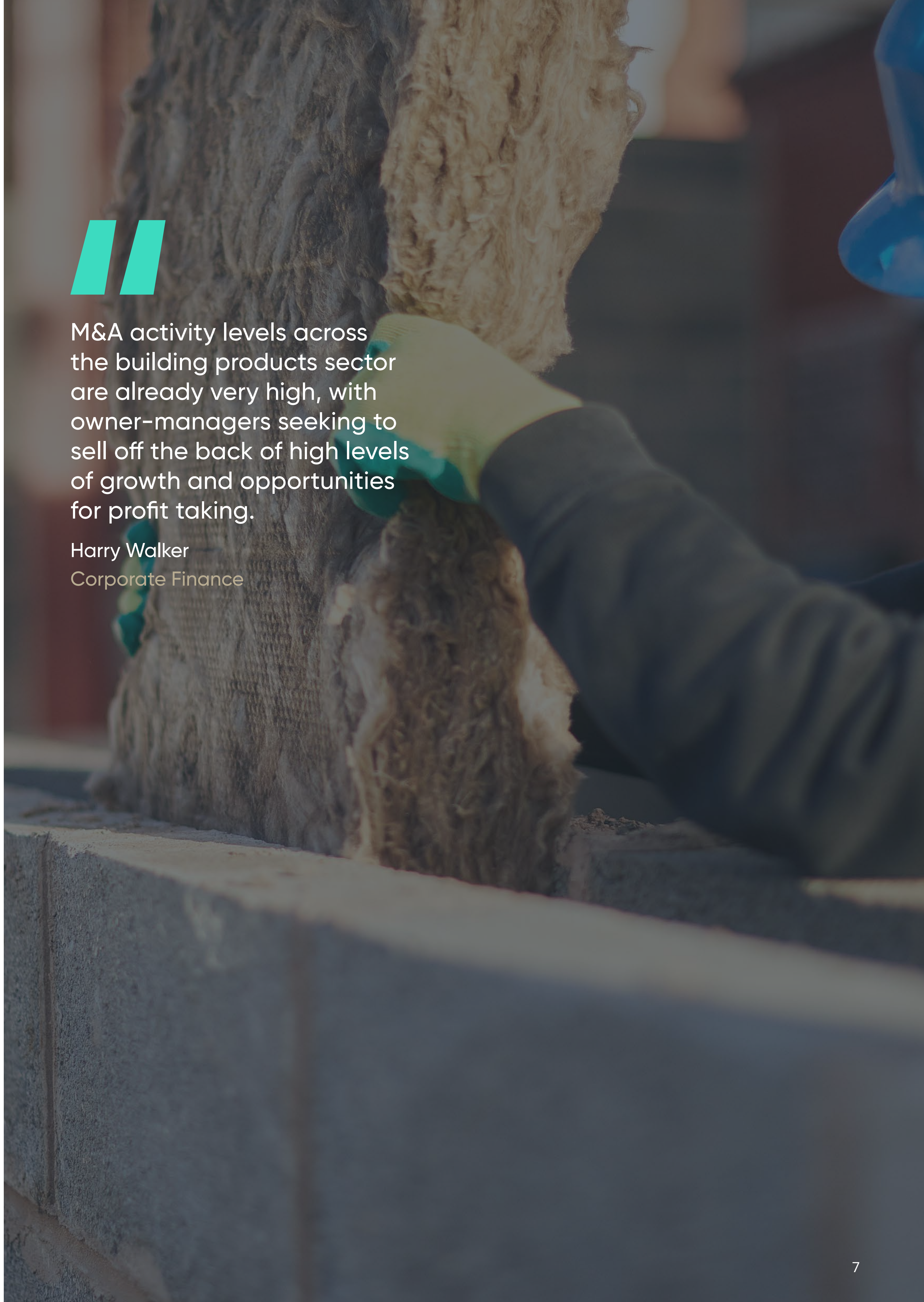
As things stand, the situation is still relatively benign as HMRC is only pursuing enforcement where there is evidence of criminality or fraud or escalating collection where there is no contact from a debtor. The prohibition on winding up and statutory demands ended on 30 September 2021, and we may see a change in stance from suppliers and critically HMRC.

However, it will be useful to see the impact of these pressures returning and whether HMRC starts pursuing these firms more vigorously. We are unlikely to see any substantial increase in restructuring volumes until 2022, but directors will need to make difficult decisions in the meantime. In construction services, M&A activity is likely to pick up as well-funded firms will find opportunities to acquire businesses that have secured a pipeline of contracts but lack the liquidity or capacity to deliver on them.

M&A activity levels across the building products sector are already very high, with owner-managers seeking to sell off the back of high levels of growth and opportunities for profit taking, as well as the stress of owning a business amidst the extreme challenges of lockdowns, record demand levels and supply chain challenges. The larger merchant groups are generally pursuing a strategy of divestment of their light side distribution businesses to focus on their core merchanting activities, a trend which pre-dates the pandemic. At the same time, several national merchanting players have themselves been acquired by UK and international private equity investors, which is likely to fuel further buy-and-build activity in the sector. Well-funded private businesses, and those that responded successfully to high demand coupled with supply chain challenges will also be cash-rich and ready to acquire competitors who have struggled, as well as successful niche players looking to exit to larger groups.

Looking at forecasts for the UK economy, a rebound in consumer spending will help generate GDP growth of 7.3 per cent in 2022, the highest for 74 years, falling to 1.7 per cent in 2023[4]. Demand in the residential market is likely to reduce as the home improvement boom abates, which will take some pressure off supply chains.

Increasingly important in the medium term will be appetite for big infrastructure projects, and whether the government sustains investment in national infrastructure projects. Many of these projects rely on foreign support to some extent, but inward investment fell by more than half to £14.2 billion in 2020. Stimulating this investment will be key.



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Conclusion

The coronavirus pandemic has accelerated a number of existing trends in the UK construction sector, exposing the vulnerabilities of many contractors and the UK's reliance on overseas supply chains.

In the short term, many firms will be preoccupied with accessing the supplies and staff they need to fulfil their contracts, with no lack of demand for their services. But the sector is effectively experiencing hyperinflation, bringing significant planning challenges and the threat of overtrading.

That said, scheduled infrastructure spending and high levels of demand in the domestic improvement market offer the opportunity to create pipeline security for the months ahead, and opportunities for consolidation and high growth exist for businesses able to balance demand and supply challenges. Those firms who secure advice early, plan ahead and proactively engage with customers and lenders will find they can weather this storm and flourish in the future.

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Martyn Pullin
Restructuring Advisory

FRP Advisory Trading Limited

110 Cannon Street

London EC4N 6EU

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