Real Estate Matters

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Construction & Real Estate Newsletter

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Contents

MHA report: Further decline in construction sector's fortunes with suppressed sales, turnover and profits

The UK construction industry has experienced a further year of slowdown in sales, turnover and profits pointing to a sustained downward trend, according to latest UK Construction Sector Report.

Turnover growth continues to slow with larger firms hit hardest

Year on year decline puts squeeze on profit margins

Sales cool as depressed demand and Brexit uncertainty bites

Stalling profits highlight potential labour costs exposure

Turnover in the last year grew 5.3% but was in marked contrast to the 14.1% increase recorded over the past two years, revealing a slowdown in the industry's growth. Larger businesses, those with turnover of £200m and over, continue to experience a decline in turnover levels with the average dropping by 13.8% this year.

In the face of this decrease, larger firms have reduced their workforce numbers from last year, with the average number of employees reducing from 878 to 777. Elsewhere, staffing levels remain static. The extension of the IR35 legislation 'off-payroll' rules for the private sector, which comes into force in April 2020, is likely to see employment numbers rise and with it, the potential impact on prices or further squeeze on margins. However, there appears no apparent material increase in employment numbers at this stage.

While the average gross profit margins are in double figures across the board, it is the smaller companies (under £25m turnover) that have seen the highest margins of between 20-25%.

For mid-tier firms (£100-150m turnover) the margins drop to just over 14% (14.4%) and larger firms have seen a decline to 11.2%

Overall, average margins are declining year on year and for the larger firms the fall in turnover and the desire to maintain workforce continuity, as well as general competitive pressures, are behind the squeeze. In a post Carillion world, the report seems to indicate these firms are looking to improve profitability rather than chase turnover.

A slowdown in the sector is further emphasised by the biggest fall in new work for a decade according to the IHS Markit/Cips UK construction PMI survey. This together with a lack of new infrastructure projects and major developments and a depressed demand created by Brexit uncertainty, are also contributing to the slowdown. All these factors contributed to a decline in sales growth across all turnover brackets with the largest companies actually contracting over the past two years.

Whilst there is a general upward trend in dividends, the levels have fluctuated across the different sizes of firms. The smaller firms have either remained static or seen a decline. Most notably, those in the £5-10m turnover bracket saw a significant decrease in pay outs of 85.6%; this is in marked contrast to a leap of nearly 250% the previous year. For the largest businesses there was a 60% decrease in dividends from last year compared to a 17.1% rise over a three-year period.

The overall construction industry's profit before tax performance showed a decline in 2019 with only small firms experiencing increases, although these were lower than two years ago. For the larger companies, who saw the biggest declines – the largest drop being from £46m last year to £26.3m in the current year – lower profit before tax is the inevitable result of reduced turnover and margins. Companies in this group will undoubtedly try to reduce overheads, but this tends to be difficult in the short term as certain costs are fixed. This does raise the prospect of future labour cost-cutting.

Robert Dowling, Head of Construction and Real Estate at MHA, comments

"It remains a challenging time for the UK's construction industry. Nationally, firms have managed to maintain similar levels of profitability with slightly lower gross profit margins than last year. But the indications of a downward trend are there. Declining workloads and the potential impact these may have on profits could mean tougher times ahead for some firms. At such times it is important that firms adopt and maintain disciplined and strong management whether that is remaining focused on your core specialisms or strengthening the balance sheet by retaining higher levels of profit.

"Firms should look at technology investment and the implementation of strategies to reduce tiers of management whilst retaining key personnel and the adoption of robust project risk management; all of which can enable firms to ride the downturn and even prosper.

"It is impossible to talk about the future prospects of the industry without mentioning Brexit. Beyond the impact of the current uncertainty, the industry could even stand to gain from a post-Brexit boost and any UK government commitments and plans for infrastructure investment will be warmly welcomed."

MHA's national outlook on the UK construction sector used company accounts information published by credit reporting agency Experian, for construction firms in England, Scotland and Wales with an annual turnover of between £5 and £200m+.

Visit: mha-uk.co.uk/insight/publications/ to read the full report.

Funding Property Development in England and Wales

In May 2019, the then Housing minister Kit Malthouse said the Government targeted the building of 222,000 new homes. This was more than built in all but one of the last 31 years and its development accelerator Homes England would continue to provide assistance to build properties more quickly.

As a government-backed initiative, the Home Building Fund also reflects wider government priorities including:

- obtaining value for money for the taxpayer;
- supporting projects that focus on areas of high affordability pressures;
- supporting projects that help the SME developer market, brownfield developments or innovative developments; and
- assisting applicants who can demonstrate that without this funding the scheme would not progress as quickly or would not progress at all.

A large part of this assistance by Homes England directed towards Small and Medium-Sized Enterprises (SME's) developers is The Home Building Fund. The Fund provides Development Finance Loan funding to meet the development costs of building homes and Infrastructure Finance Loan funding for site preparation.

We consider some of the funding options for the SME property developer outside of their first points of call of their existing bank or their funds. Certainly, for SME developers seeking to build more than five homes, the use of their own funds (or indeed of their family and friends) may soon be exhausted. If there are project delays or unforeseen problems, then the build-up of financial pressures may mean their family and friends may find themselves exhausted too!

This is where The Home Building Fund seeks to make a difference. Its lending will require appropriate security, typically against property assets, and can be provided on either a short- or long-term basis. And it may be able to unlock developments that would not otherwise happen.

The Fund offers development finance loans of over £250,000, typically for a period of up to five years. Whilst the infrastructure finance is available before 31 March 2021, loans for development finance can be drawn down until 31 March 2023. The Fund provides loan finance which can work alongside other forms of financial support too, so subordinated lending will be considered.

This may allow the developer of at least five properties to use their existing high street banker along with their income from off-plan sales or sales of completed homes to pull together a funding package that can allow the whole of the project to be developed whilst minimising the number of external loan costs.

One final point is that the developments must be in England, though other areas within the United Kingdom have similar support schemes. The Wales Property Fund can provide two-year loans of up to £4m for residential and mixed-use developments only in Wales, including loans up to 65% of Gross Development Value or 100% of build costs.

Within the North East of England, seven local authorities have combined to work together to secure a £10m Fund operated by FW Capital to offer development funding to local SME housebuilders. The aim is to help kick start the development of small-scale property schemes throughout the North East.

Similar to the scheme in Wales, two-year loans are available. However, in the North East, Property Fund loans are limited to £1m to fund development costs.

Furthermore, within other English regions, there may be additional support. So, it's wise to speak to your corporate finance adviser to understand the financing options available to fund property development.

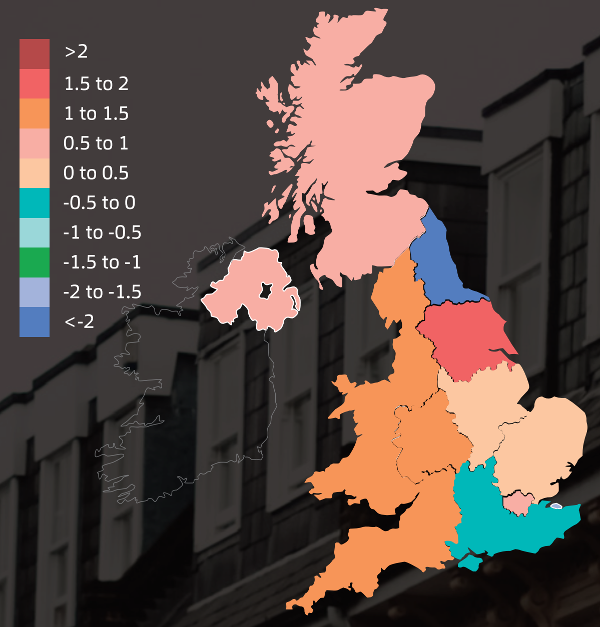
House Price Growth

The Office for National Statistics has recently released the House Price data for July 2019. The published data shows the slowest rate of growth in UK house price growth since 2012, driven mainly by a slowdown in the south and east of England.

£233,000
In July 2019

which is up **£2,000**
on the same time last year.

Monthly House Price Changes



On an annual basis house prices are still edging up overall, albeit that the rate of growth has been gradually slowing since mid-2016. The average UK house price in July 2019 was £233,000 which is up £2,000 on the same time last year. On a non-seasonally adjusted basis, this is an increase of 0.5% as compared to an increase of 1.2% a year earlier.

In England house prices increased by 0.3% over the year to July 2019, with the average price now £249,000. Scotland saw house prices increase by 1.4% over the last 12 months to stand at £154,000. Wales was the top performer with prices increasing by 4.2% to an average of £165,000. Northern Ireland remains the cheapest place to purchase a property in, with the average house price at £137,000.

On a regional basis, London continues to be the area with the highest average house price at £478,000, but London showed a reduction in prices with a fall of around £7,000 in the average price in the past year. London is followed by the South East and the East of England, which stand at £320,000 (down 2% in the year) and £292,000 (down 0.5% in the year) respectively.

The North East continued to have the lowest average price at £127,000 and prices fell by 2.9% over the last year. The strongest growth was in Yorkshire and the Humber where prices rose by an average of 3.2% in the year to July 2019. The percentage change for the month of July is shown in the graphic above.

New build properties showed an annual 2% increase in price in the latest figures but those for the most recent month showed a 1% decrease in prices achieved. For existing property the figures were +1.2% on an annual basis and +0.4% for the latest month available.

As regards the property type, all property types except flats and maisonettes showed growth in the year to July 2019; semi-detached and terraced houses had the strongest growth with both at 1.1%. Flats and maisonettes showed the weakest performance with a reduction in prices of 0.3%% overall for the past year. As mentioned last time, there has been some coverage in the press about the effect of the tax changes for buy to let owners starting to reduce prices in this area of the market as investors are beginning to see how the changes affect them individually. Commentary from certain quarters regarding rights to buy for tenants will probably not help.

Construction & Real Estate | Insolvency

The real estate market is experiencing a significant downtown which is being felt by a number of related sectors. It is a sector that is sensitive to changes in the business lifecycle and the downturn is starting to trigger financial stress as we are now starting to see increasing levels of corporate insolvencies. In Q1 2019, there were 121 insolvencies and it is the second most common sector affected by insolvency.

The market has historically taken advantage of low interest rates and high liquidity. However, with the political uncertainty of Brexit, this sector has been facing economic challenges due to the depreciation of Sterling over the last couple of years causing residential property prices across the UK to fall.

Construction

Insolvency statistics reflect that capital-intensive sectors such as construction, manufacturing and steel depend on the stability of the real estate market.

The construction industry is starting to see increased levels of insolvencies as growth slows as a result of currency depreciation and lower government spending. This sector is particularly at risk due to the increasing cost of building materials and falling property valuations. This has not only affected the company itself but also the supply chain and those contracted to work on various projects.

Companies which use fixed-rate contract terms increase the risk of under-performing contracts with projects over-running both in duration and cost, placing pressure on already narrow margins.

These companies have incurred considerable sums of capital expenditure on expanding their capacity with a significant proportion of the investment funded through raising US Dollar debt.

Unfortunately, many of these companies have been unable to generate the projected turnover and profits as economic growth has slowed. Furthermore, the appreciation of US Dollar has placed additional pressure on these companies' ability to service the debt.

Last year we saw the collapse of construction giant, Carillion, and in Q1 2019, the construction sector had the second highest number (799) of corporate insolvencies. The construction industry is likely to continue to suffer and it is only a matter of time before we see another large name fail.

Housing

In the UK, a significant proportion of people's wealth is tied up in house prices. When there is an increase in property values, it results in a 'wealth effect', and when prices decease, it causes the reverse effect therefore bringing down consumer confidence and their appetite to spend. In October 2018, sales figures reflect a 3% decrease in white goods purchased by consumers who are moving to a new house.

The collapse in residential property prices was last seen in 2008 and pressure on the UK housing market is likely to continue with the uncertainty caused by Brexit. This, combining with increasing cost of raw materials (due to a weaker Pound) and employment costs (due to a shortage of EU migrant workers and UK workers insisting on higher wages) has caused a ripple effect of insolvencies and paints a gloomy picture for this sector.

How MHA can help you

We have extensive experience of dealing with real estate in insolvency related situations. These include advising landlords / tenants and receiverships over low and high value properties.

With several recent cases of high street retailers restructuring under Company Voluntary Arrangements (CVA), it is crucial to have an understanding of property insolvency and the options for both landlords and tenants.

Example – The insolvent tenant

The financial obligations under a lease can be one of the largest expenses for a business.

We can explain the impact of various insolvency processes to you, assess your options and help you understand your rights as a landlord of an insolvency tenant. If you have received proposals for a CVA, we can help you interpret the proposals, complete the voting forms and attend meetings of creditors if required.

Where the tenant is in Administration or Liquidation, we have access to specialist property and insolvency solicitors to assist landlords with the negotiation of any deeds of surrender or licences to assign that that they are asked to consider.

Example – The insolvent landlord

We can assist tenants in understanding what could happen if the landlord becomes insolvent, understanding who assumes responsibility for management issues, maintenance and insurance obligations that the landlord would ordinarily be responsible for.

Conclusion

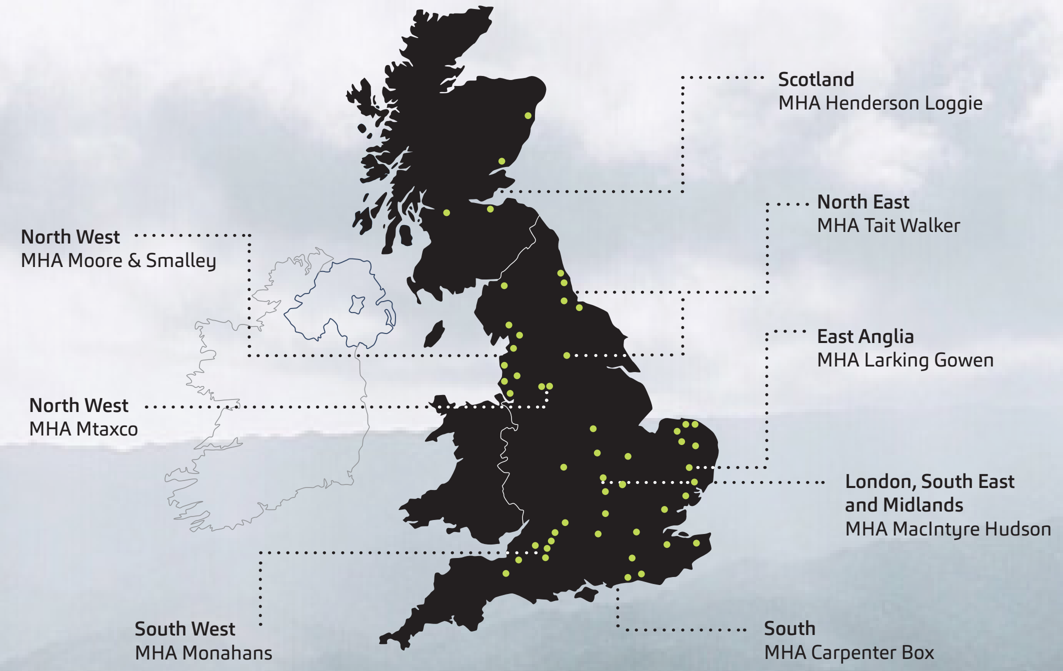
Whether or not your business operates in the real estate sector we recommend that you obtain appropriate advice at the earliest opportunity in order that we can assess your position and ensure you have many options to consider as possible. At MHA we will always exhaust the informal or turnaround options before recommending other, more formal options.

About MHA

MHA is an association of progressive and respected accountancy and advisory firms with offices in over 50 locations across England, Scotland and Wales. We provide both national expertise and local insight to clients. As an independent member of Baker Tilly International, a top 10 global advisory network, MHA offers clients unparalleled access to a broad range of in-country international specialists where overseas projects are on the horizon.

Our Sector Approach

MHA allows clients to benefit from in depth sector knowledge in addition to specialist accountancy services and expert business advice. Construction and Real Estate is a key sector for MHA, and our industry experts understand the challenges and opportunities within the sector. With MHA's sector experience, and local, national and international knowledge, our team is well placed to provide leading advice.



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