UK Construction Sector

Report 2019

Now, for tomorrow

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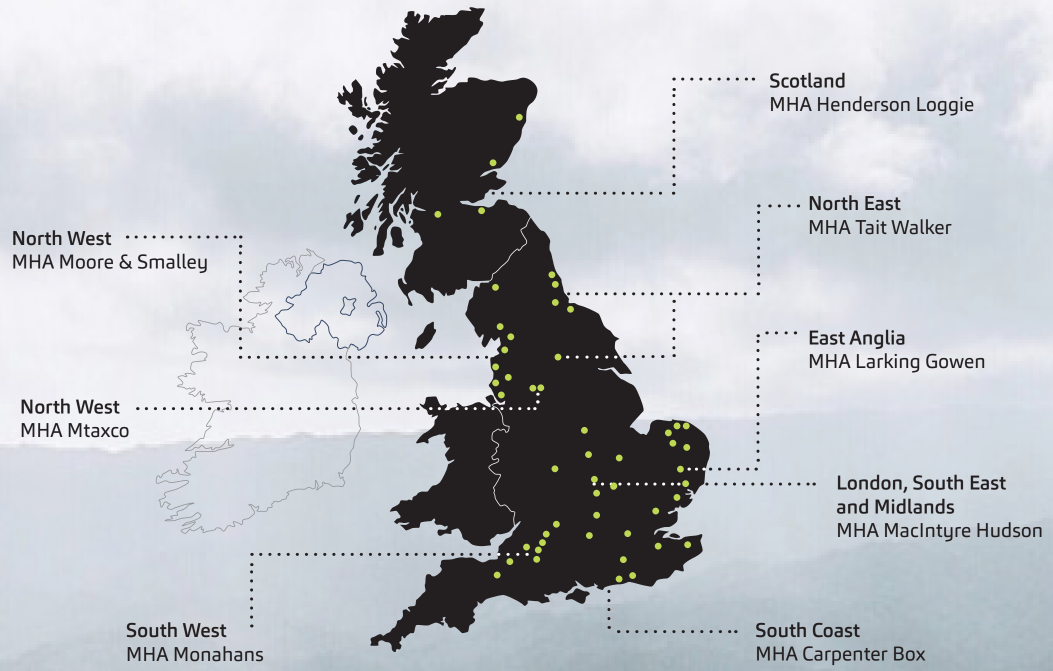
About MHA

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.



National Reach

50+
Offices nationwide

8
Independent accountancy firms

International Reach

125
Member firms in 145 territories

10th
Largest network in the world by combined revenue

Combined turnover of
£143m

US$3.6bn
Combined member firm revenues

Our Construction and Real Estate team looked at operating and accounts data from 2,158 construction companies with operations across Great Britain.

By splitting the data into six turnover brackets, we've enabled you to benchmark your financial and non-financial data. This report is based on information from Experian which was available as of 7 July 2019. This is the second edition of our UK Construction Report, which has seen the MHA Construction and Real Estate group refine and improve the methodology used for analysing the available data.

Turnover Brackets

£5 - 10m	352
£10 - 25m	963
£25 - 100m	709
£100 - 150m	85
£150 - 200m	34
£200m +	15
Total	**2,158**

Total figures

Year	Accounts ending 2016/17 (CY-2)	Accounts ending 2017/18 (CY-1)	Accounts ending 2018/19 (CY)
Turnover	£66,154,799,656	£71,660,349,219	£75,474,280,335
Gross Profit	£11,109,399,033	£12,007,723,742	£12,308,426,784
Gross Profit Margin	16.79%	16.76%	16.31%
Profit Before Tax	£6,685,918,560	£6,792,019,257	£6,708,479,433
Taxation	£621,990,357	£634,990,718	£647,465,150
Dividends	£1,586,932,560	£1,936,829,059	£2,040,391,410
No. of Employees	237,297	237,486	241,766

Regional Split

East of England	270	**Scotland**	199
London	424	**South East**	317
Midlands	299	**South West**	120
North East	62	**Wales**	61
North West	238	**Yorkshire and The Humber**	168
		Total	2,158

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Financial Considerations

The tax liabilities for most turnover brackets remained stable with £150-200m seeing a slight decline of 5% from 2017/18 to 2018/19.

Although the industry is still growing, there is a clear overall trend across all groups of an industry slowdown.

Turnover

There has been a slight turnover increase year on year across the industry for the past three years, barring a consistent decline for £200m+ businesses.

Turnover has increased 14.1% over the past two years (16/17 to 18/19) 5.3% was reported in (17/18 to 18/19) showing a slowdown in growth.

Larger businesses over £200m have seen a 16.3 % decrease in turnover over the past two years and have been the hardest hit.

These Larger businesses have turnover which is dependent on timing, size of contract and the fact that projects are non-recurring.

Gross Profit Margin

Despite significant falls in sales growth, profit margins have remained relatively static with overall averages for the industry declining slightly year on year. Smaller companies under £25m have demonstrated the highest gross profit margins, ranging between 20-25%. This drops as low as 14.4% for businesses in the £100-150m range, although the figures pick up again for the £150m+ businesses.

The only group to show a marginal increase in their gross profit margin over the past 12 months was £10-25m (0.9%). All companies across the remaining turnover brackets experienced a slight decline, highlighting that the post Carillion resolution to improve profitability rather than chase turnover seems to have taken root across the board.

Growth in Total Sales

Companies across all turnover brackets have seen a decline in sales growth, with the largest companies actually contracting over the past two years. These figures demonstrate diminishing work opportunities. This can be attributed to Brexit uncertainty but is also a reflection of the lack of demand for construction services generally we have seen in the last 12–18 months.

Although the industry is still growing, there is a clear overall trend across all groups of an industry slowdown. Commentators have referred to this for some time and the lack of new infrastructure projects and major developments have contributed. Brexit has also depressed enthusiasm for speculative builds.

Taxation

The £200m+ bracket had significantly higher tax liabilities, which corresponds with the PBT trend identified above. The tax liabilities for all other turnover brackets remained relatively stable with £150-200m seeing a slight decline of 5% from 2017/18 to 2018/19.

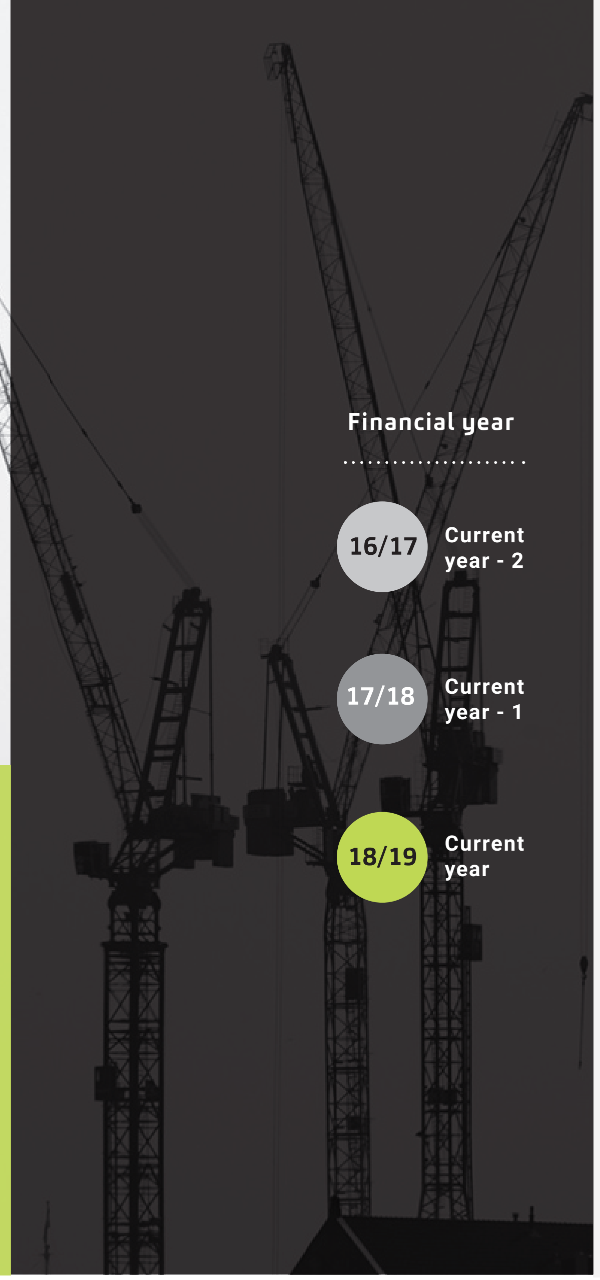
Profit Before Tax

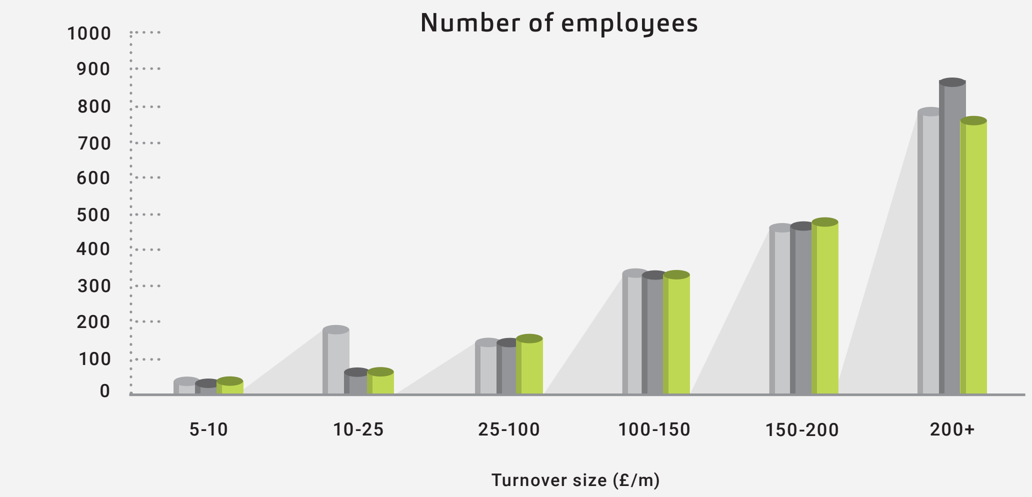
Smaller companies had a slightly higher Profit Before Tax (PBT), although almost all sizes showed a decline this year – the largest decline being £200m+ dropping from 46 to 26.3m. However, these figures confirm earlier trends of static or declining growth, with declining PBT figurers across almost all turnover brackets. £5-10m and £10-15m businesses saw a 6% and 23% increase in PBT from 2017/18 to 2018/19 respectively, although these are still lower figures than two years ago.

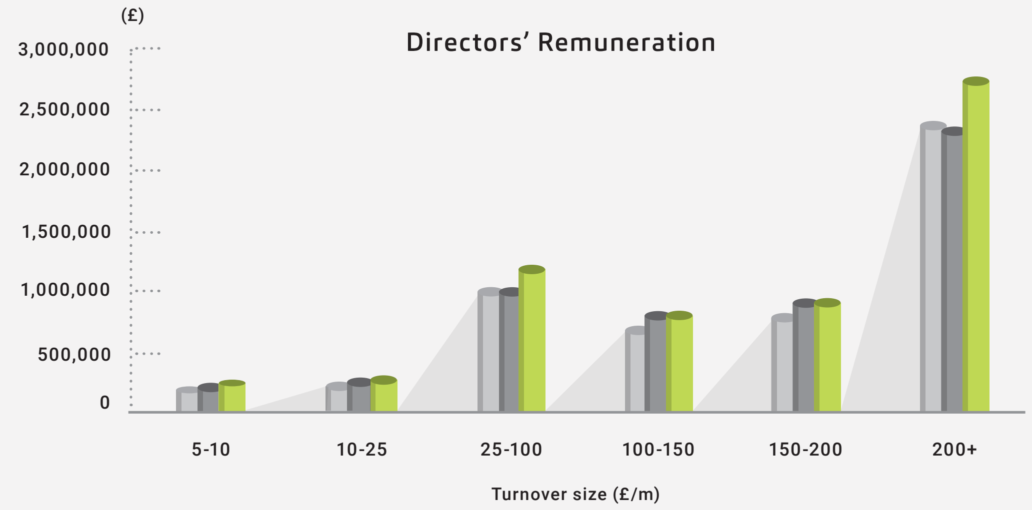
For the £200m+ turnover companies lower turnover and reduced margins inevitably means lower PBT. Companies in this group will undoubtedly try to reduce overheads but this tends to be difficult in the short term as certain costs will be fixed in nature. Labour tends to be the easiest cost to cut.

Employment and Remuneration

While there is a general upward trend in dividends, particularly for larger businesses, smaller businesses have seen flat or declining dividends being paid out.







Dividends

Outgoing dividends have fluctuated across business size. While there is a general upward trend in dividends, particularly for £200m+ businesses, smaller businesses have seen flatter or declining dividends being paid out. In particular, companies between £5-10m saw a massive 85.6% decrease in dividend pay outs in 2018/19 following a big jump of nearly 250% the previous year.

Larger businesses over £200m saw a 60% increase in dividends from 2017/18 to 2018/19, following a jump of 17.1% from 2016/17 to 2018/19.

Number of Employees

These figures seem fairly flat, but they mask the disruption at the higher end of the market. Overall, the employee numbers were steady for companies under the £200m turnover size, but we can see a large decrease in employee numbers for companies over £200m turnover from 878 to 777 on average. As they are showing significant decreases in turnover, a reduced headcount is expected.

Our statistics for the total figures show employee numbers moving from 237,486 in 2017/18 to 241,766 in 2018/19; in other words, very little change. It would appear that the cutbacks by £200m+ corporates have been filled by the other groups.

Interestingly, there appears no apparent material increase in employment numbers with the new renumeration rules coming into effect 1 April 2020, which HMRC will be anticipating.

Directors' Remuneration

Almost all groups increased directors' remuneration year on year. The £25-100m bracket had the largest increase of almost 200K. The groups have increased year on year with the exception of £100-150m and £150-200m which remained stable. It is surprising to see that despite the static profits companies haven't cutback on directors' remuneration pay.

Highest Paid Director

There is obviously a clear relationship between directors' remuneration and highest paid director. All remuneration is in line with the average financial performance of the companies within each turnover bracket.

Remuneration to directors can fluctuate due to performance of the company and personal needs of its owners. However, it is fair to say the general increase in the total directors' remunerationhas seen the corresponding increase in the pay of the highest paid director.

Interestingly, there appears to be no apparent material increase in employment numbers with the new renumeration rules coming into effect 1 April 2020.

Business Funding

All turnover brackets appear to have increased their current borrowings for 2018/19, apart from £10-25m which saw a slight drop of 4%.

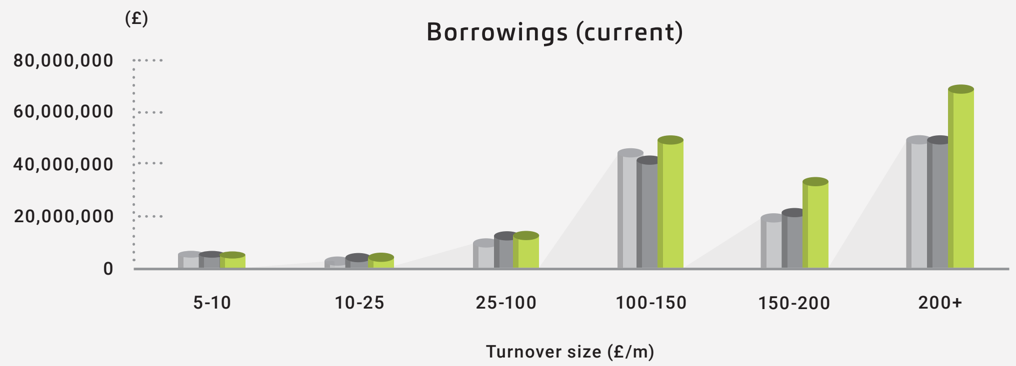
Working capital remained stable for turnovers of £5-150m year on year, with an increase in 2018/19 for turnover brackets of £150m+.

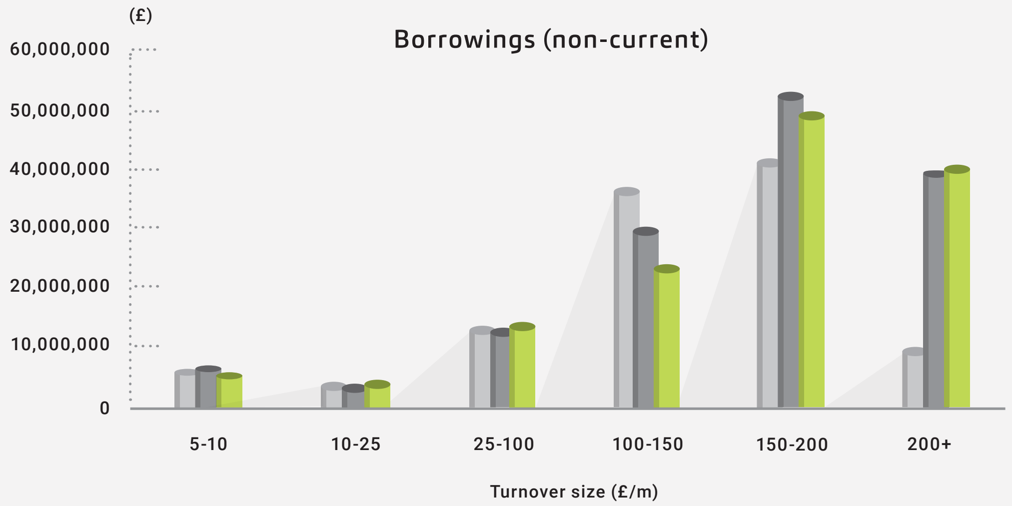
Financial year

16/17 Current year - 2

17/18 Current year - 1

18/19 Current year





Current Borrowings

All turnover brackets appear to have increased their current borrowings for 2018/19, apart from £10-25m which saw a slight drop of 4%. The £150-200m bracket showed the highest increase in higher current borrowings (up 51.7%) in comparison to the other turnover brackets.

Non-Current Borrowings

The £5-100m groups all displayed relatively stable long-term borrowings across the data timeframe. In contrast to this, the companies within the £100-150m bracket reduced their long-term borrowings year on year, although compensated by increases in short term borrowings.

One doesn't expect to see material changes in borrowings for those companies in the turnover brackets between £5 - 100m as they tend to struggle to obtain bank funding.

Those in turnover brackets from £100–200m+ will see borrowings that fluctuate depending on the nature of their work and their investment strategies. For the companies with turnover over £200m, they have increased their total borrowings.

Working Capital

Working capital remained stable for turnovers of £5-150m year on year, with an increase in 2018/19 for turnover brackets of £150m+. Businesses over £200m+ turnover saw a slight uplift in working capital from last year (up 0.66%).

Although £200m+ turnover companies have experienced a reduction in turnover, margin and pre-tax profit, they have materially improved their working capital. This has been an objective of the larger corporations following the demise of Carillion.

Summary of the Year

In conclusion, it is clear from our analysis of UK construction companies with a turnover of up to £200m that, regardless of how companies may operate, there are a number of common trends:

Nationally the sector has seen turnover rise slightly, gross profit margins decline slightly, but PBT has increased marginally. Companies have managed to maintain a similar level of profitability with slightly lower gross profit margins.

Sales growth year on year is slowing down, reflecting concerns over Brexit and a lack of demand for services.

25%

Highest gross profit margin was within £5-10m with just under 25%.

Profits are being retained but with increasing dividends the amount retained is declining. Is this good risk management?

Future Gazing
The Next 12 Months

The industry could be in for a tough time where good management must prevail.

Government funding of infrastructure projects should increase once Brexit is resolved, giving a boost to those involved. However, there is always a time lag which could affect viability.

The general consensus and stated policy of the major construction companies is to improve margins. They talk optimistically of a net profit of between 2% and 5% of turnover.

To do this they say they will be more selective on the work they undertake. However, if their workload declines as a result of lack of investment by government, local authorities and investors, will this be achievable in the short term? Indeed, the industry could be in for a tough time where good management must prevail.

- Companies that 'stick to their knitting' by working in markets they are familiar with, with clients they know and in areas they have worked in the past, should survive and may even prosper if Brexit is resolved sooner rather than later.
- The demise of Carillion indicates that it is not easy to evaluate the status of contractors and their viability. This must put in doubt mergers of any significance. Indeed, why would anyone buy a construction company unless there were strategic merits (expertise, land bank client base) that outweighed the inherent risk of taking over existing contracts. This would really apply to any company in the industry irrespective of size. Any growth is likely to come from internally generated opportunities and, unfortunately, the demise of competitors.
- Those contractors working in housebuilding, student accommodation and the private rental sector (PRS) should still see continuing demand but volumes may decrease.
- Housebuilders may get acquisitive if they do not have the land banks of oven-ready sites in areas where there is demand. Up to now there has been plenty for everyone but areas are tightening up in demand so national housebuilders may look at regional players or expand their geographical spread to move into areas of demand.
- Government funding of infrastructure projects should increase once Brexit is resolved, giving a boost to those involved. However, there is always a time lag which could affect viability.
- Will Brexit cause contractors to have less labour and therefore capacity leading to a reduction in turnover? There is unlikely to be an immediate restriction on labour coming into the UK post-Brexit. However, if the value of sterling continues to fall, will the UK still be attractive to overseas workers?
- Offsite manufacturing will continue to gain traction but is unlikely to make the margin impact or improve quantities that many are expecting.

April 2020 sees the implementation of legislation designed to counteract disguised remuneration. This should mean employment numbers will rise. However, it could bring with it a significant increase in costs. Will the end users adjust their prices upwards or will margins come under attack? Construction News has just published its annual survey of the top 100 construction companies by turnover.

Key points of interest:

5

First increase in average margin for 5 years.

74%

Turnover has flattened but pre-tax profits have improved by 74%.

52

52 out of thetop 100 had no borrowings; this was animprovement on the previous year.

In summary there appears to be the view that chasing turnover is not a driver, but margin and profitability are the order of the day.

Maximising Opportunities

The current year will be another challenging year for the sector. Risk management will be more important than ever, ensuring that the contracts construction companies enter into are properly costed and fully understood, with parties they can rely on and who will pay.

The key for business owners is to continually appraise their business, in order to maximise on the opportunities available and avoid potential pitfalls.

Below are just some of the areas of potential opportunities we are working with our clients to explore:

- Research and Development Tax Relief, which many are missing out.
- Capital Allowances relief on investment in plant and equipment.
- Employee Management Incentive (EMI) share schemes to encourage staff retention and bonus schemes.
- Refinancing opportunities whilst interest rates are low.
- Buying smaller competitors or affiliates to enhance service offering.
- Re-evaluating supply chains and sub-contractors to ensure value for money and business continuity.
- Eliminating low margin high risk projects.
- **Looking at expanding markets such as:** residential/commercial builds, data centres, student accommodation, Buy to Rent and retirement homes.
- De-risking contracts by getting contractors and their staff to fully understand their obligations and ensure they are followed.

Unfortunately there are potential draw backs:

- Brexit "hangover" may continue to supress development and speculative builds.
- Starter homes only available to first time buyer under 40 with prices capped at £250k outside London and £450k in the capital with minimum of 20% discount.
- Increased material cost due to devaluation of sterling.
- Mayor of London looking for 35% of affordable housing in any development thereby potentially reducing the appetite to build.
- Permitted development opportunities – where initially there was low hanging fruit, these opportunities may now dwindle, as commercial refurbishment may have more value.

Proposals that would help in the next 12 months if implemented:

- Stamp duty eliminated for first time buyers.
- Exempt stamp duty for over 65's who are downsizing.
- Heathrow – needs to be fast tracked.
- HS2 committed to or develop Northern Powerhouse Rail, connecting Liverpool and Hull with Newcastle, Sheffield, Manchester and Leeds.
- Crossrail 2 to be fully supported by government as well as the mayor.
- Amending regulations on the retentions held by the main contractor.
- Eradicate late payment practices by applying penalties.
- Tax initiatives to contractors to develop offsite construction.
- Brexit determines that the movement of labour is not to be materially restricted.
- More support for trainees to come into the construction industry and become a career choice.
- Eliminate the double tax of the Apprenticeship Levy and Construction Industry Training Board (CITB) contributions.
- Increased government funding on infrastructure projects to give a post Brexit boost.

Potential Management Initiatives:

1. Retain higher levels of profits to strengthen balance sheet.
2. Slim down management tiers- unlikely to be able to reduce salaries but headcount reduction may be advisable.
3. Avoid the 'killer contract' - easier said than done but risk management of projects should be as strong as ever.
4. Secure key personnel by long term incentives.
5. Develop your key areas of strengths - look for niche offering.
6. Understand the potential benefits of the use of technology – create a team to look at potential utilisation and benefit.

Regional Analysis
East of England

The East of England is the third-largest region in the survey after London and the South East. It represents 12% of the total survey population in terms of the number of companies it captures. Whilst these businesses may be based in the region, a significant number are involved with contracts and developments within London and the wider South East region.

Our experience is that margins have been under pressure on all businesses in the sector.

This means they are generally operating in regions where there has been sustained house building and general construction activity in recent years. The overall results of the report in the East of England are mixed, with the feeling of more uncertainty and more challenging conditions creeping into the overall theme.

Turnover and Profitability

It is striking that whilst the first four groups with sales up to £150m managed to increase turnover and activity, the top two groupings both saw decreased turnover. This trend was most marked amongst the largest businesses in the region. This is consistent with the national picture and could, in part, be due to a redistribution of contracts to lower-tier companies post Carillion. Several larger companies may well have also reflected on the viability of some larger public sector type work.

All turnover brackets apart from one saw reduced or flat margins, reflecting pressure on the cost of materials due to several factors, including Brexit. Our experience is that margins have been under pressure on all businesses in the sector, but especially those involved with contracting work due to the lead times between pricing the work and buying materials.

Despite margin pressures, the lower four groups all managed to report increased profit before tax, partly driven by higher outputs but also continued control of overheads, a continuing trend.

In recent months there has been a worrying increase in the number of businesses finding themselves in difficulty in the sector.

Employment

Both average employees and total wage costs were largely flat across all the groups, even those that reported increased turnover. This is surprising and it is possible that as the numbers in our survey don't include self-employed individuals or agency workers, it has missed some employment figures.

It is well documented that the industry continues to have a shortage of skilled labour across the UK, with these pressures particularly prevalent in the South and East, and this will remain a key feature over the foreseeable future. The CITB, for example, forecasts that some 25,000 new construction workers will be needed in the East of England between now and 2023.

Other Notable Features

One of the most striking features from a review of the rest of the data in our survey was that every group reported increases in the level of trade debtors, and in some cases this was significant. In recent months there has been a worrying increase in the number of businesses finding themselves in difficulty in the sector, and this has almost certainly been due to the impact of unexpected bad debts in many cases.

Looking Forward

There are good reasons why activity levels in the Eastern region should at least continue or improve over the next few years. There are works on the A14 upgrade, significant mixed development around Cambridge, including the university's North West development, ongoing works on the £1 billion Purfleet regeneration and several offshore projects like the £2.5 billion East Anglia One development and its associated onshore grid work which is underway, to name just a few.

Of course, the extent to which these involve businesses actually located in the region will vary. Furthermore, the outcome of all the many different permutations related to Brexit means it is difficult to predict what story next year's survey will tell.

Regional Analysis
London

The companies registered with London postcodes totalled 424. Many companies will be operating outside this area, so some are must be taken in the interpretation of data in terms of its application to London.

In a post-Grenfell and Carillion world, the industry remains ever-evolving, with the impact of technological advancements, changes in safety compliance and the increase in prefabrication and modular construction projects coming to the forefront. The latter remains an emerging sector, not least because of the speed, cost and flexibility offered.

It is also giving developers the ability to explore and exploit new markets. The ability to take advantage of 'air space' and rooftop developments has opened a host of new opportunities in the otherwise congested centre of London.

Sales and Gross Profit

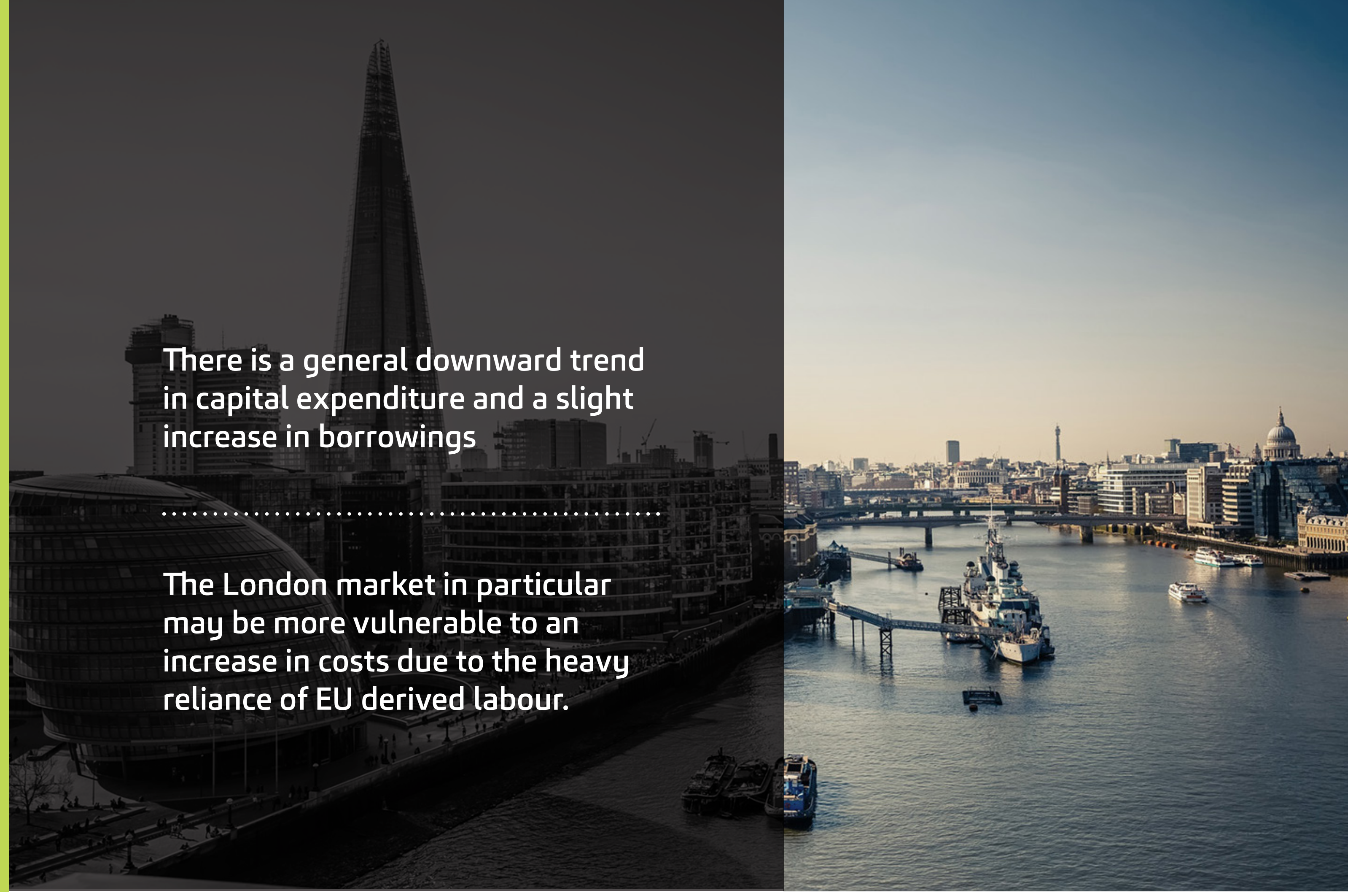
For several years there has been a deterioration in the performance of the construction industry's largest firms. However, this year, the top 100 companies in the industry appear to have turned a corner. The UK's biggest contractors appear to have changed course: with a more conservative approach to trading as many of the firms moved from expanding the top line to focus on the bottom line.

Whilst this trend is reflective of companies in our survey with turnover over £200m (turnover has declined 23% and gross profit margin has decreased 6.6%) companies at the opposite end of the scale paint a different story. Companies with turnover up to £25m have shown a year-on-year increase in sales of just under 155% whilst gross profit margins have remained consistent. Companies in the £100-150m range have remained static in terms of both turnover and gross profit.

Profit, Profit Extraction and Remuneration

Although mainly attributable to the larger corporates, there is an overall improvement in profit before tax. However, when looking at dividend extraction, the £100-150m band shows an increase in dividends while smaller companies generally show decline.

Companies with a turnover up to £150m have had an increase in employment numbers which is mirrored by an increase in staff costs. Companies with turnover up to £100m also showed an increase in directors' remuneration. Many of the larger contractors have been through an overhead reduction programme which is reflected in a decrease in staff numbers, staff and directors' remuneration (including a reduction in the remuneration of the highest paid directors).



There is a general downward trend in capital expenditure and a slight increase in borrowings

The London market in particular may be more vulnerable to an increase in costs due to the heavy reliance of EU derived labour.

The ongoing uncertainty surrounding the market puts these firms in a better place to absorb the loss of revenue should demand decline further.

Liquidity, Working Capital and Borrowings

There is a general downward trend in capital expenditure and a slight increase in borrowings which, coupled together with the reduction in dividends and remuneration above, contribute to the improvement in profitability and working capital.

Following Carillion's collapse, there is an increased focus on underlying financial health and placing greater value in liquidity, working capital and leverage. It was noted last year that the larger companies were improving their working capital. This trend continues this year and the smaller companies now appear to be following suit.

There is a mounting pressure on the industry that requires prudent financial and business planning, to face a potentially challenging year ahead.

Looking Forward

As the Brexit-saga continues to rumble on, it is widely thought that this uncertainty is holding back activity in the market, as buyers and sellers sit tight. The Pound has weakened against the Euro, pushing up import costs. There is also huge uncertainty over the loss of migrant workers. The London market in particular may be more vulnerable to an increase in costs due to the heavy reliance of EU derived labour.

Many firms believe there is a perfect storm brewing and are painfully preparing themselves for the expected rough waters ahead.

With the additional burden arising from the introduction of legislative changes such as the VAT domestic reverse charge (delayed now until 1 October 2020) and the extension of IR35 rules into the private sector from April 2020, contractors are facing an increasing level of challenge and cost.

We don't have to look far to see that the collapse of a giant rippled through the entire industry to smaller businesses. With the uncertainty around the current political and economic environment, greater scrutiny on performance and price, there is a mounting pressure on the industry that requires prudent financial and business planning, to face a potentially challenging year ahead.

Regional Analysis
Midlands

It is clear that uncertainty over Brexit continues to impact all sectors of the UK economy, with commercial property investment levels seemingly no exception. Investment volume across the UK dropped to its lowest quarterly total since the aftermath of the EU Referendum in Q3 2016.

Heightened investor caution leading to the UK's scheduled exit from the EU has clearly been reflected in investment activity. £10.9 billion of assets changed hands in the quarter, 26% below average and a substantial 34% below Q4 2018, the largest recorded quarter-on-quarter percentage fall in five years. A significant number of regional property professionals feel the market is in some stage of a downturn, particularly those based in the East Midlands who are at odds with their colleagues in the west of the region. Despite this sentiment, there is no feeling of a "hard" landing at this stage.

Regional Investment

Commercial property investment across the Midlands has fallen as the ongoing Brexit impasse continues to have a negative impact on the market. Compared to the same time last year, Birmingham and the West Midlands saw a 33% drop in investments, with a 54% decrease on the figure for Q4 2018. Across the East Midlands there was a decrease of 67% and a 66% drop in investments compared to Q4 2018.

We still have no idea what Brexit will look like. Having said that it would appear that, notwithstanding the fall in volume alluded to above, the Midlands as a whole seems to be faring much better as a region as it is still seeing reasonable investment levels when compared to other regions despite the concerns of what may (or may not) happen on 31 October.

Looking Forward

Birmingham and its surrounding regions continue to be buoyant in terms of investment in commercial property and infrastructure. The city itself is an ever-changing landscape of new developments and regeneration.

Last year predicted that we expected to see gross margins come under increasing pressure due to supply side factors. This is borne out in this year's data.

Furthermore, the slowdown in sales growth year on year is continuing to reflect the increasingly frantic concerns over Brexit. The prudence of companies of all sizes in retaining profits for challenges to come continues as levels of retained profits and cash have increased since last year.

Heightened investor caution leading up the UK's scheduled exit from the EU has clearly been reflected in investment activity.

Birmingham and its surrounding regions continue to be buoyant in terms of investment in commercial property and infrastructure.

Regional Analysis
North East

The construction sector is a key and vibrant part of the North East economy. Despite challenging market conditions, there were some positive highlights coming from the business data used in this report.

The size of companies analysed in the North East were typically those with a turnover between £10 and £100m. The companies came from a wide range of sectors including house builders, civil contractors, facilities management providers and property portfolio owners.

Sales, Profit and Taxation

The data highlights that SMEs in the region with a turnover of less than £100m are experiencing slower growth, when compared to last year. The average business dropped to 3% growth for their most recent financial year (compared to 5% in 17/18).

It's still a mixed picture in the region. Some North East businesses servicing the London, South East, Manchester and Liverpool regions continue to thrive. However there are growing concerns that there is a slowdown in London and the South East driven by political uncertainty. The Q3 ICAEW Business Confidence Monitor showed that whilst the Northern accountants were the most optimistic in England about future growth, it was those in London where optimism fell again in the quarter.

Conversely, the construction and property sectors nationally showing a marked increase in optimism compared to the first two quarters of the year but they still show negative sentiment. Despite reduced growth, gross profits were on the rise for some of the groups. In particular those in the £10-25m and £25-100m brackets saw gross margin rising by 1.5% in the current year. This was a mixed picture, with larger companies (£100-200m) showing decreased margins. Yet this group showed an increase in collective profits before tax to a level that was up 24% in two years

There was a mixed picture in respect of Corporation Tax. Mid-size companies (£25-100m) saw a reduction in tax paid to less than a third of the previous year whilst larger companies (£100-200m) showed collective Corporation Tax payments increasing 3% after significant growth in their reported profit before tax.

The data highlights that SMEs in the region with a turnover of less than £100m are experiencing slower growth, when compared to the previous year.

Despite reduced growth, gross profits were on the rise for some of the groups. In particular those in the £10-25m and £25-100m brackets saw gross margin rising by 1.5% in the current year.

Employees, Dividends and Equity

Average employee numbers showed steady growth in businesses in £5-10m turnover range of around 2%. However, employee numbers fell for the mid-size companies, with an average decrease of around 3%.

Average directors' remuneration for mid-size companies increased by 17% compared to last year but are still 10% lower than two years ago. This is a measure of shareholder-directors' ability to extract profits and reward themselves in times of good trading conditions. Whilst it shows an improvement it suggests that trading is not as good as it was a few years ago.

Business Funding and Borrowing

Surprisingly, and despite anecdotal evidence of increasing business challenges due to late payments from customers, there has not been a reported increase in working capital requirements for mid-size companies. Overall, banks appear to have increased their lending to this sector and total current borrowings for all businesses below £25m turnover almost doubled.

Looking Forward

Looking to 2019/20 there should continue to be greater opportunities for those North East construction firms who are resilient, who serve outside of the region and who can get involved in the larger civil engineering projects associated with the Advanced Manufacturing Park and the significant Teesside developments that are being planned.

There will hopefully be an end to political uncertainty for the country which should spark renewed confidence and greater public expenditure that will benefit the order book of North East construction companies in the years to come. However, 2020 may be too early for this to be seen in reported profits.

Regional Analysis
North West

The region had predicted measured growth in the sector. This year we analysed 238 businesses, representing 11% of our national survey.

Turnover

Half of our subsets, including the two smallest, have delivered real terms growth since last year, unlike the previous two years where a clean sweep of growth was seen. This is also more volatile when compared to the national picture.

Profitability

The North West has also endured falling gross margins, apart from the smallest companies. Of greater concern is the size of some falls and the overall average margin dropping from 21.0% to 17.7%, representing a reduction in contract contributions by one-seventh. What is notable, however, is the halving of gross profits within the largest companies.

There is a disparity in the average pre-taxation profit movements of companies on either side of the £100m turnover mark, where smaller companies have grown profits. Beyond this, average profits have fallen echoing the national analysis. For context, this is perhaps a slight correction from the movements seen last year and a consequence of the larger and less agile overhead bases belonging to larger companies.

Profit Extraction and Equity

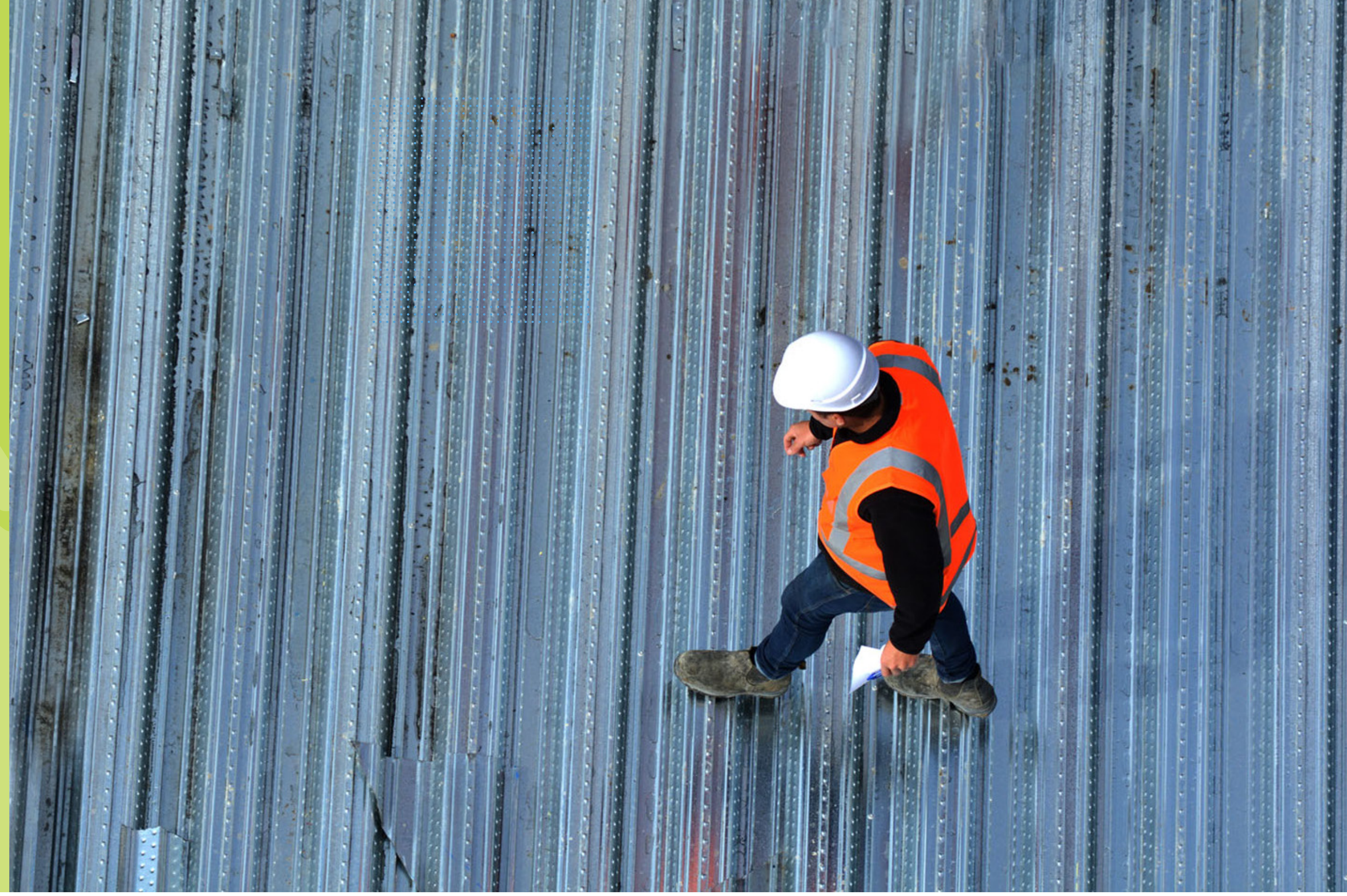
There is a small increase in declared dividends with the largest percentage increases being seen in the smallest companies. After a significant drop in distributions last year, it appears shareholders are comfortable enough to draw on retained profits but at sensible levels given future unknowns.

This prudence is also reflected in director remuneration, where the average levels have fallen and only those companies below £10m turnover have risen.

Consequently, net assets levels continue to rise across all brackets as owners take a measured view for the future albeit this is seen to a greater degree as turnover increases.

Employees

Average numbers across the region were static this year, with 15% falls in the £200m+ bracket being offset elsewhere, in line with national averages. The impending IR35 changes in 2020 may see this rise in the future, but against a backdrop of skilled labour shortage, something which a 'hard' Brexit will not assist with. However average pay levels in the region are attractive compared to many sectors which will assist in meeting demand.



The impending IR35 changes in 2020 may see this rise in the future, but against a backdrop of skilled labour shortage.

Working Capital and Borrowing

Whilst average total borrowings rose only slightly, there was an increase in short term debt and a fall in longer-term balances, particularly within the smallest companies in our sample. This could indicate a reduction in medium-term investment or increasing operational funding requirements. Given it is sometimes harder to assess contractor strength than one might imagine (Carillion, anyone?) this is noteworthy.

There was an increase in short term debt and a fall in longer-term balances.

Looking Forward

Like our analysis above, there is a little more volatility across the national picture, but there appears to be significant optimism within the region compared to other parts of the UK. This is driven by a continuous trend towards city centre living, typified by the number of cranes currently operating in Manchester city centre, Salford and Liverpool. The North West is a desirable place to reside, more so for those who would have made a beeline to London in the past.

Significant and varied developments outside of the largest conurbations are in rude health. Examples include the Eden Project North, in Morecambe, the Wirral Waters project and the mass residential build to the North of Preston and into the Ribble Valley. Although residential development is key, both to buy and rent, civil projects still have traction.

Discussions with our clients tell us that business owners are keenly aware of their business models. They are cautiously optimistic, but ready to make changes should the regional economy experience shocks due to recessionary forces, short term Brexit reactions or changes in government policy. Indeed, it could be these external factors which provide the greatest challenge to sustaining the buoyancy experienced in our region since 2013.

Regional Analysis
South East

Across the three-year review period there is an overall trend of either consistent or improving profits in the sector.

However, the largest of the companies seem to have had their gross profit margins noticeably eroded over the last three years.

Turnover Growth

Regional turnover growth in the South East is broadly in-line with the national trend, which is to be expected due to a concentration of activity in the region.

Most businesses within the sector have experienced a steady increase in turnover growth over the three-year period, with the exception of those businesses reporting a turnover of more than £200m. It is these largest of the construction companies that have continued to experience a decline in their revenues.

This suggests a conservative approach to construction projects in the region. This is likely to be driven by Brexit uncertainties resulting in an element of hesitancy to commit to major projects and to get them off the ground.

However, the aftershock of the failure of Carillion may also have contributed, with decisions being taken for projects to be spread amongst lower-tier construction companies, who can adapt to increase their capacity to undertake government and infrastructure works.

Gross Profit

Companies at the lowest end of the turnover scale continue to report the best gross profit margins. As company activity increases up to the £150m level there is then a continued decrease in gross profit margins achieved.

The sweet spot appears to be those construction companies with a turnover in the region of £150 to 200m who are not only experiencing revenue growth, as highlighted above, but also now reporting a better gross profit than those companies with a revenue of more than £200m. The largest of the companies seem to have had their gross profit margins noticeably eroded over the last three years. This may be due to labour and materials prices, possibly as a result of the value of sterling.

Profit Before Tax

The general result year on year is a reduction in net profitability, although in the previous year some of the largest companies experienced a significant increase in profits. This reflects the volatility of the construction market.

Across the three-year review period there is an overall trend of either consistent or improving profits in the sector.

Employees and Director Remuneration

There are no noticeable trends in the region, other than employment levels have generally remained steady across the last three years for companies with revenues of up to £200m.

As expected, where the largest of the construction companies have experienced a reduction in their activities, they have been able to keep their workforces flexible and have employed less workers. This may be a positive sign that there is an increase in potential labour supply and could help to relieve some of the market pressures on the cost of labour.

Director pay and the highest-paid directors have remained broadly consistent across the three-year period, reflecting current market conditions. However, as expected, those companies with revenues of more than £200m link director pay with results. There is a clear correlation of company performance and director remuneration across the three-year period.

Business Funding

The industry continues to suffer from infrequent and delayed customer receipts, which has resulted in stretched working capital requirements.

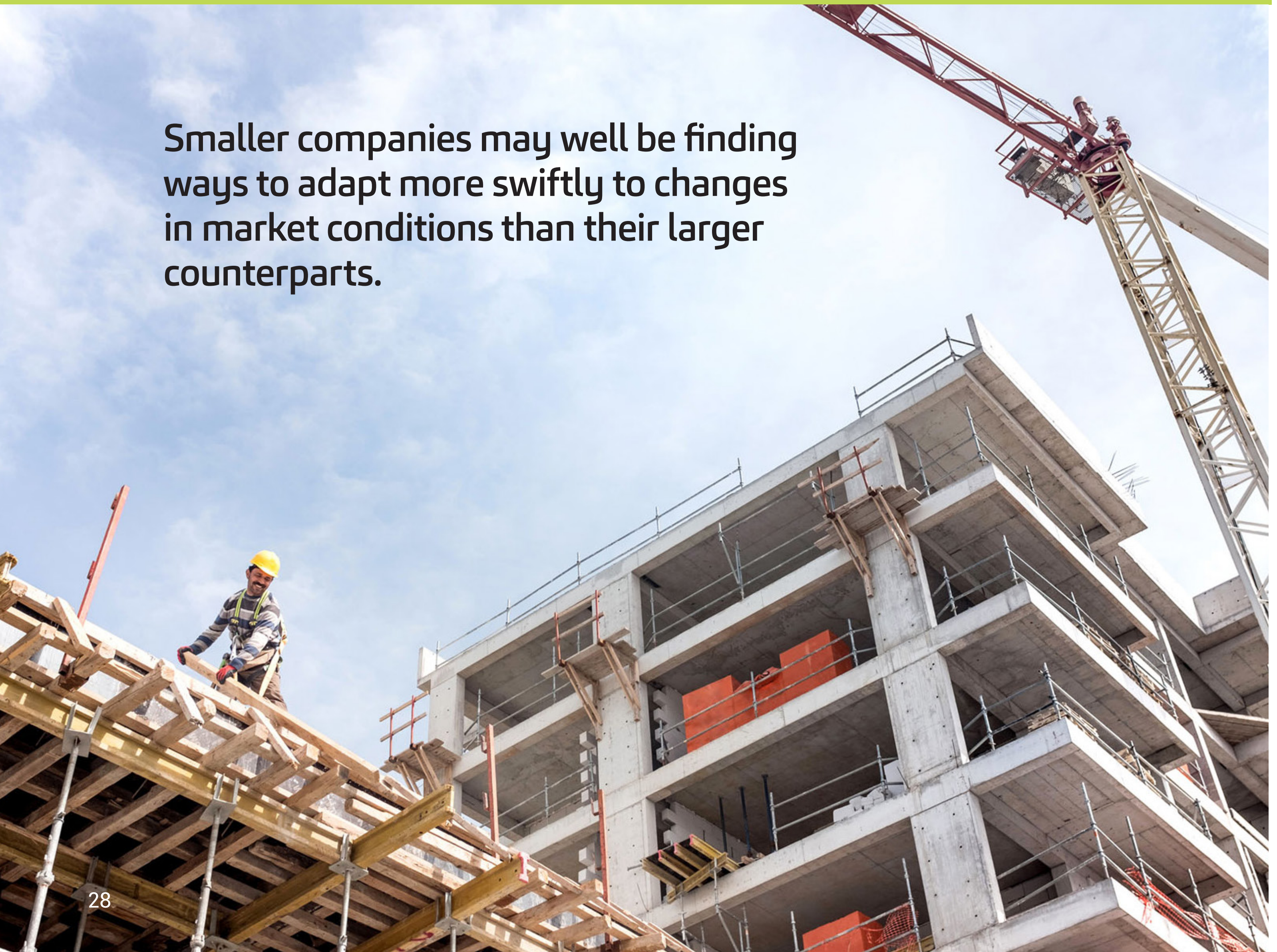
An interesting trend emerging is an increase in their short-term lending and a reduction in long-term borrowing. It is well known that most high street lenders have in the past retracted from the sector for the SME market, mainly due to the fragility of the smaller construction business. This increase in short term debt may be due to niche lenders and challenger banks coming onto the market with new products, including invoice discounting and factoring alternatives. It may also be partly due to the change of attitudes of management to accept these alternative lending products, whereas in the past they were a potential indication of financial distress.

An interesting trend emerging is an increase in their short-term lending and a reduction in long-term borrowing.

Regional Analysis
South West

It has been a fascinating year of statistics for the construction and real estate sector in the South West. In all, we have surveyed 120 companies in the region, and compared these with over 2,100 nationally.

Smaller companies may well be finding ways to adapt more swiftly to changes in market conditions than their larger counterparts.



Turnover, Profit and Taxation

The trend in turnover for the South West has fairly consistently mirrored what has happened nationally: there has been modest growth in almost all size sectors other than in the very largest of the companies in our sample where turnover has consistently fallen over the last few years.

Gross margins, on the other hand, have tended to be much more modest in the South West, when compared to the national average. Again, at the largest end of our sample, nationally margins have stayed moderately consistent, whereas in the South West, companies have suffered significant gross losses in certain cases.

The smaller end of the sector shows the best rate of gross margin again this year, with the South West showing consistent improvements, slightly bucking the national trend. However, margins locally are still much lower than across the rest of the UK. Smaller companies may well be finding ways to adapt more swiftly to changes in market conditions than their larger counterparts. The very low unemployment rates locally could be impacting gross profits at all size levels here, much more than elsewhere in the UK.

Pre-tax profits have consistently improved across almost all sectors in the South West, although despite those improvements they are still some way off the national average. Once again, there have been some big loss-makers at the upper end of the market locally.

Staffing, Management Remuneration, and Dividend Payments

Perhaps not surprisingly, average staff numbers at the larger end of the sector in the South West have fallen dramatically over the last three years. This is inevitably in reaction to falling sales and the losses that have been sustained.

The average number of staff at this level is now slightly less than half of what it was three years ago. This is inconsistent with the national picture where, although staff numbers have also fallen, it has been nowhere near the same extent.

At most other levels, the trend has been more consistent with that nationally, although the South West generally tends to employ fewer people than across the rest of the UK. Unemployment levels in the South West are amongst some of the lowest nationally and that getting any staff, let alone good staff, is becoming increasingly difficult. This is inevitably having an inflationary impact on wages as more firms compete for a shrinking resource.

Directors' remuneration, however, has remained largely static locally for the last three years. That is apart from at the largest end of our market where, perhaps not surprisingly, it has fallen away quite significantly. The national trend has been rather more buoyant with static or improving levels of remuneration across all size businesses.

Dividend payments on the other hand have outperformed the national averages at the smaller end of our region this year, despite slightly lower profitability. Conversely, at the upper end they have all but evaporated as larger companies seek to contend with the losses that they have sustained.

Investment

One other stand out statistic is the extent to which investment in plant locally does not mirror the national picture. At every level companies locally have invested far less than the national average, in some cases to a huge extent. At the biggest end of our market investment has all but ceased, perhaps because of the losses that have been sustained.

Looking Forward

The biggest uncertainty in the economy remains Brexit, and this is inevitably having a dampening effect on investment. The labour market is tightening, which is only likely to get worse as immigration caps continue to bite. In order to survive, companies will need to start to think of ways of working with fewer people. Inevitably this will require increased investment in plant and technology. The ongoing uncertainty around Brexit, with the consequential effects on exchange rates and the cost of borrowing, makes medium-term decision making extremely difficult.

Regional Analysis
Yorkshire and Humber

This year we analysed 168 businesses in the Yorkshire and Humber. After predictions of measured growth last year, the region has performed reasonably well.

Turnover

Half of our subsets, including the two smallest, have delivered reasonable growth over the last three years, the growth appears slow when compared to the national picture and more volatile.

Profitability

Despite gross profit margins falling across all groups this year, groups one and five do show gross profit margins considerably higher than the national averages. Of greater concern is the size of some falls and the overall average margin dropping from 21.0% to 17.7%, representing a reduction in contract contributions by one-seventh.

There is a disparity in the average pre-taxation profit movements of companies on either side of the £100m turnover mark, where smaller companies have grown profits. Beyond this, average profits have fallen echoing the national analysis.

Profit Extraction and Equity

The data for the region shows there is an increase in declared dividends with the largest percentage increases being seen in the largest companies. After a significant drop in distributions noted last year in smaller companies, it appears shareholders are comfortable enough to draw on retained profits this year, with small increases visible in groups one to three but at sensible levels given future unknowns.

This is also reflected in director remuneration, with marginal increases across the last three years. With the exception of group five, which showed a significant increase for the current year

Brexit, changes to Government policy and other economic factors will play a key part in the next year. It will be interesting to see how the data compares in 2020 and beyond.

The impending IR35 changes in 2020 may see this rise in the future, but against a backdrop of skilled labour shortage, something which a 'hard' Brexit will not aid.

Employees

Average numbers across our region were static this year, which is in line with national averages. The impending IR35 changes in 2020 may see this rise in the future, but against a backdrop of skilled labour shortage, something which a 'hard' Brexit will not aid.

Working Capital and Borrowing

Average total borrowings remained fairly static for most groups, showing a very steady, but marginal increase across the last three years. With the exception of businesses in the £100 - 150m, which showed a staged decline in borrowings, with a significant decrease in the current year. Whilst average total borrowings rose only slightly, there was an increase in short term debt and a fall in longer-term balances, particularly within the smallest companies in our sample. This could indicate a reduction in medium-term investment.

Looking Forward

Like our analysis above, there is a little more volatility across the national picture, but there appears to be significant optimism within the region compared to other parts of the UK. This could be driven by continuous development across the region, an increase of city centre living and a rise of student accommodation needs in major cities such as Leeds and York.

Discussions with our clients show that whilst optimistic, this optimism comes with caution after seeing some of the industries biggest names fall in recent years. Brexit, changes to Government policy and other economic factors will play a key part in the next year and so it will be interesting to see how the data compares in 2020 and beyond.

There is a little more volatility across the national picture, but there appears to be significant optimism within the region compared to other parts of the UK.

Regional Analysis
Scotland

Leading trade and government organisations have highlighted a significant decrease (in excess of £1 billion) in the value of the industry in Scotland over the last 12 months.

In Scotland it is the mid-tiered companies £100 - 150m which have seen the largest growth at 17.5%.

Furthermore, concerns have been raised around the number of people employed by the sector with some quoting a decrease of 8,000 people over this same 12 month period. Whilst this report can neither confirm nor dispel these statements, the analysis below does point to there being more stability than recent headlines would suggest.

Sales, Profit and Taxation

Nationally turnover has increased by 5% on average with large gains being made by the smallest (£5-10m) and largest companies (£200m+) with increases of 17% and 19% respectively.

Scotland is following the national trend in some areas but not all. Overall turnover across the sector has increased by 2% on average which aligns with inflation. However, the smallest and largest companies buck the national trend with a decrease of 2% in both groups. In Scotland it is the mid-tiered companies (£100 - 150m) which have seen the largest growth at 17.5%.

Gross Profit Margin

Scotland is following the national trend when it comes to gross profit margin overall with the gross profit remaining consistent at 17% on average. However, there are more significant fluctuations when analysing the individual groups in Scotland.

The smallest companies (£5-10m) are following the national trend with a 1% reduction in gross profit margin to 23%. The mid-tiered companies (£100-200m) are showing significantly different results to the national average. Firstly, their gross profit margin is much lower at 10% compared to 15% nationally. However, more importantly, the gross profit margin has improved significantly over the last year from 7% whereas nationally there is a 1% drop on 2018.

Profit Before Tax

Scotland has not reflected the national trend with PBT being up 8% on average against the prior year and 18% up against 2017. The grouping split shows somewhat more volatile movements than the national trend.

Companies up to £25m turnover have seen a 25% reduction in profits over the last 12 months with the national position showing an improvement. However, the largest companies (£200m+) are showing very similar results to the national average with profits down £9m on the previous year with a 57% reduction.

Employees, Dividends and Equity

Scotland has shown a small growth (4%) in workforce size over the last year. In Scotland it is the mid-sized firms (£100-200m) which have reduced their workforce the most.

Industry bodies in Scotland have been voicing concerns in recent years of a future skills shortage in the industry caused by an ageing demographic within the current workforce and a lack of young people coming into the sector. Based on this data this does not appear to be happening as yet. However, there are several other factors such as the use of sub-contractors rather than retaining staff on the payroll which could skew the data presented.

Nationally employee costs have accounted for 14% of turnover over the last three years. In Scotland this figure jumps to 18% and similarly has remained consistent over the three-year data period. This would suggest that as turnover has increased gradually over the last three years these increases have filtered down to employees through increased salaries.

Business Funding

For several years (post 2008) the industry has been relatively cautious regarding significant capital spend with any expenditure undertaken only as and when necessary. The results both nationally and regionally follow this trend once again with capital expenditure generally being lower than in both 2017 and 2018. As the threat of Brexit looms, it may be that companies became even more prudent over the last 12 months with capital expenditure spending only taking place on absolutely essential items.

Looking Forward

IR35 comes into play for the private sector in April 2020. It will be interesting to see if this has any impact on the employee results and wider financials over the next 18 -24 months with existing subcontractors, agency and self-employed individuals potentially being taken back on to the payroll as the new rules start to come into effect.

Regional Analysis
Wales

In March 2019, we had the collapse of Dawnus, which left over £50m owed to 1,500 creditors. This, along with the collapse of Carillion in January 2018, highlighted the fragility of operating a large construction firm. The reduction in turnover at the top is consistent with fewer major projects in the pipeline.

It is too early to assess the impact of Dawnus on the Welsh construction market; however, it should be expected that small to medium contractors will have taken a hit. The loss of future income streams is unlikely to be seen in the latest published accounts.

The annual growth rate for Wales has been revised to 4.6%, largely due to the timing of some major projects and the loss of one programme of work: the electrification of the rail line between Cardiff and Swansea.

Turnover and Gross Profit Margins

Wales has experienced average turnover growth in-line with the national statistics. Growth in revenue is concentrated within those entities reporting a turnover in the range of £100 to 150m, and this is expected to continue with projects such as the Central Square and Cardiff Pointe due to be completed in the next two years.

Gross profit margins in Wales are generally weaker than the national average, although companies in Wales with a turnover in the range of £150 to 200m are benefitting from a trend of increasing gross profit margins, whilst companies with a turnover in the £100 to 150m turnover range have seen a continued decline over the three years. This could be due to working capital pressures as mentioned below.

Funding

Over the three-year period, there is a clear trend of reduction in borrowings, other than for businesses with a turnover of more than £150m. This is concerning, as companies appear to have banking and lending support and products being withdrawn from them. Although financial support for the construction sector is a national problem, it appears that the majority of construction businesses in Wales are finding it more and more challenging to obtain sufficient funding.

Working capital is almost non-existent for companies with a turnover in the range of £100-150m, whilst the larger businesses appear to have a healthy level of working capital.

Employees

The largest of the companies in the region, being those with revenues of more than £150m, have reported a similar level of employment to last year, although down significantly from three years ago. It is these companies that have reported an increasing level of gross profits, so there appears to be improved labour utilisation efficiencies.

Companies in the next tier down (£100-150m turnover) are continuing to increase their workforce and may be the most exposed to adverse market conditions, especially as they are also experiencing increases in activity at lower gross profit margins.

Although financial support for the construction sector is a national problem, it appears that the majority of construction businesses in Wales are finding it more and more challenging to obtain sufficient funding.

The largest of the companies in the region, being those with revenues of more than £150m, have reported a similar level of employment to last year, although significantly down from three years ago.

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