MHA

UK Construction Sector

Report 2018

www.mha-uk.co.uk

About us

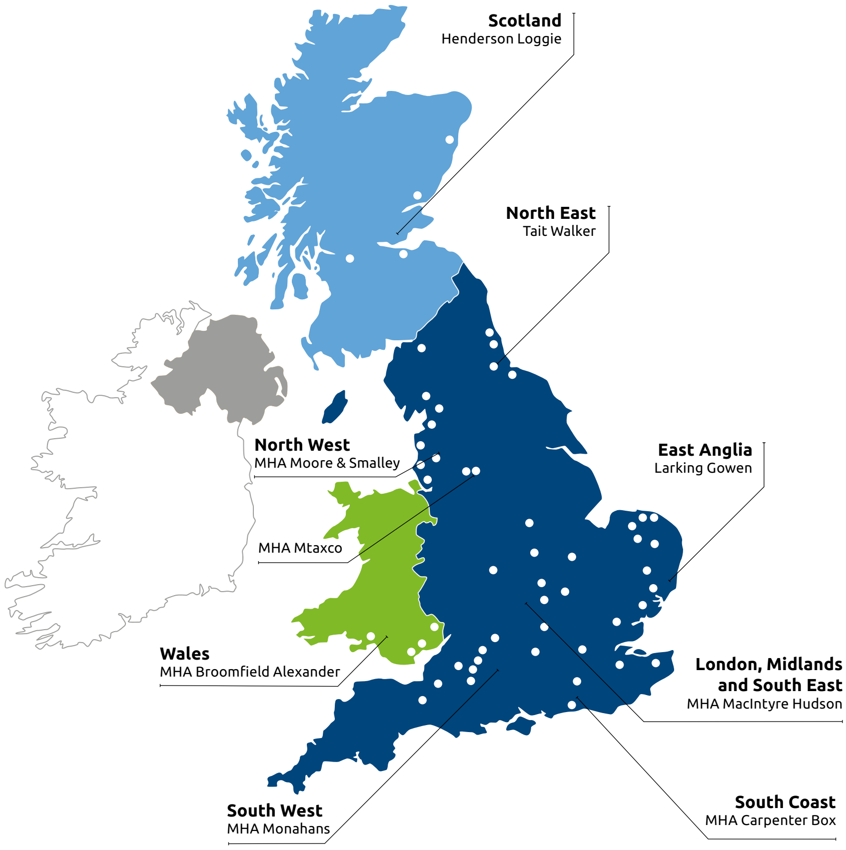
MHA is an association of progressive and respected accountancy and business advisory firms, with a dedicated corporate finance team specialising in advising entrepreneurs and owner managed businesses. As an independent member of Baker Tilly International, a global advisory network, MHA offers clients unparalleled access to a broad range of in-country international specialists where overseas projects are on the horizon.

National Reach

£140m
Combined turnover

9
Member firms

50+
Offices



Baker Tilly International

Global Reach

An independent member of BAKER TILLY INTERNATIONAL

US$3.2bn
Combined revenues

147
Territories

126
Member firms

Our Construction and Real Estate team looked at operating and accounts data from 1,708 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 30 June 2018.

Year	Accounts ending 2015-16 (CY-2)	Accounts ending 2016-17 (CY-1)	Accounts ending 2017-18 (CY)
Turnover	£52,216,080,438	£56,191,371,614	£59,953,464,270
Gross Profit	£8,023,772,831	£8,918,463,873	£9,812,098,016
Gross Profit Margin	15.4%	15.9%	16.4%
Profit Before Tax	£3,560,684,557	£3,970,527,939	£4,647,694,551
Taxation	£368,090,072	£439,558,530	£480,575,992
Dividends	£749,600,411	£924,838,241	£1,056,552,515
Retained Earnings	£11,883,378,112	£15,055,692,872	£16,455,884,621
No. of Employees	191,293	196,963	193,448

Regional Split

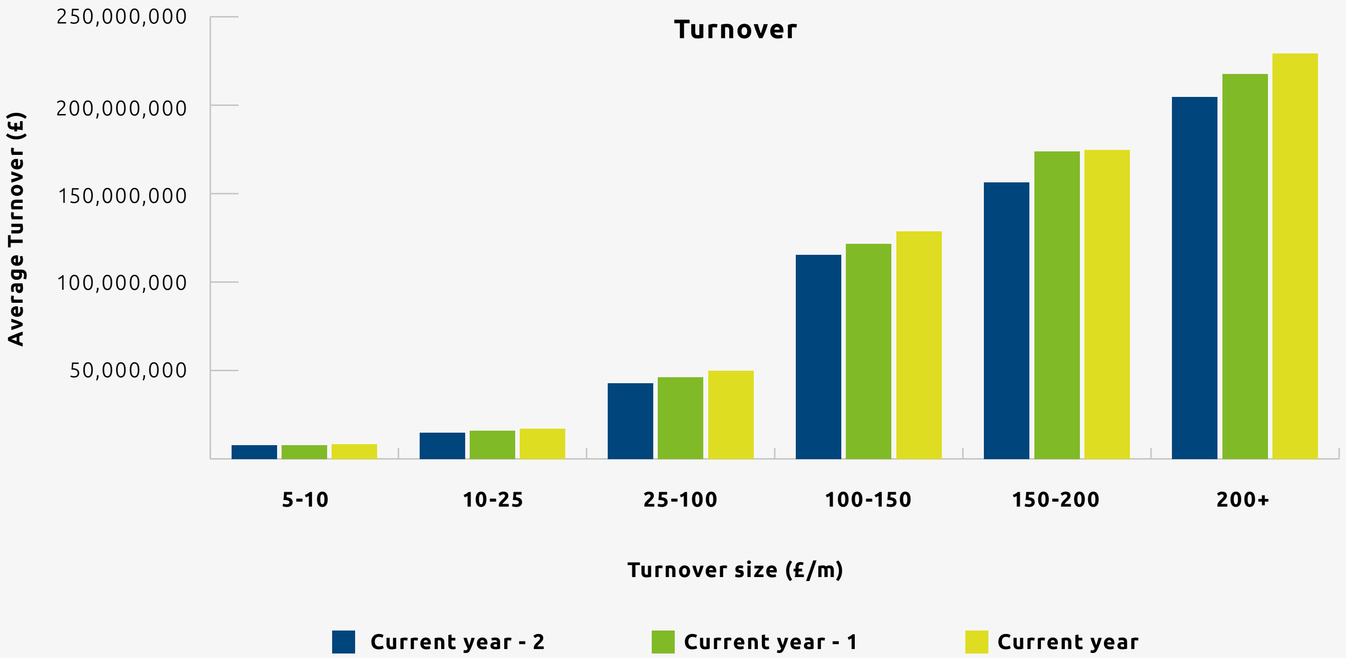
East of England	267
London	258
Midlands	247
North East	49
North West	176
Scotland	157
South East	235
South West	114
Wales	54
Yorkshire and The Humber	151
Total	**1708**

Contents

Turnover Brackets

£5m - 10m	**244**
£10m - 25m	**772**
£25m - 100m	**591**
£100m - 150m	**67**
£150m - 200m	**25**
£200m +	**9**
Total	**1708**

Financial Considerations



Irrespective of size, businesses have grown and most growth has been fairly consistent.

Turnover

Turnover has increased by 7.6% from Current Year (CY)-2 to CY-1 and by 6.7% from CY-1 to the CY, indicating a decrease in year on year growth. However, turnover does show an increase of 14.8% over the three years.

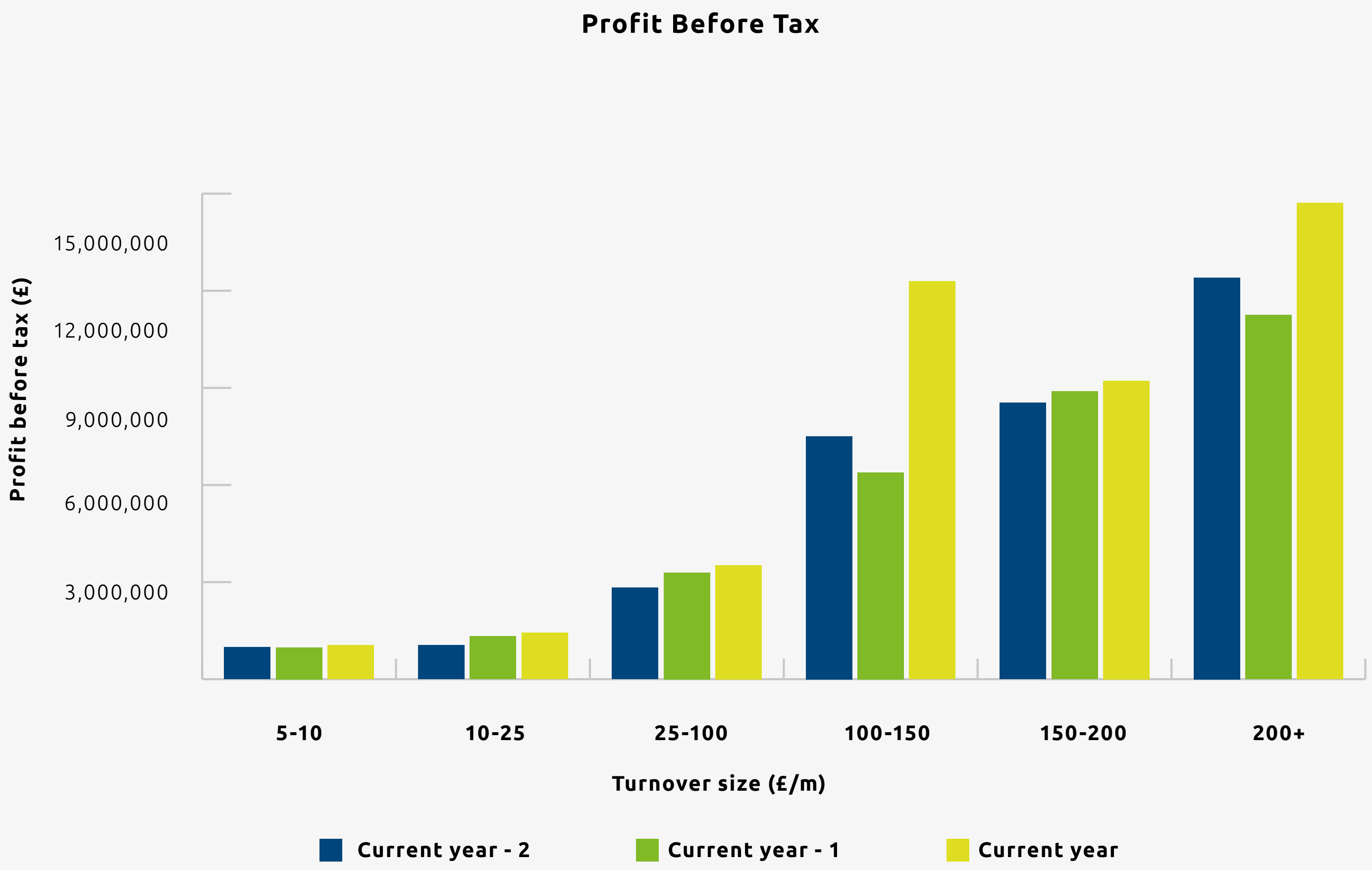
This shows that irrespective of size, businesses have grown and most growth has been fairly consistent, albeit relatively modest, bearing in mind labour costs have generally increased above inflation as have material costs.

Gross Profit Margin

Smaller companies in the £5m-10m and £10m-25m turnover brackets demonstrated higher gross profit margins. These have stayed stable, remaining at approximately 25% and 19% respectively.

All companies in the turnover brackets ranging from £25m-200m had gross profit margins of approximately 13-15%. In a similar fashion to their smaller counterparts, the margins of these categories experienced little fluctuations.

This indicates that on a national level, smaller companies may be better able to pass on price increases (labour and materials) and be more flexible in their pricing as market conditions alter. They will level to have shorter contractual time periods which can also help.



Taxation

The mid-size and large companies in the £100m-150m, £150m-200m and £200m+ brackets had significantly higher tax liabilities (CY: £1,467,112.6, £1,089,540.5 and £2,150,419.2 respectively), which corresponds with the PBT trend identified above. Additionally, the tax liabilities for the £10m-25m bracket remained relatively stable, only increasing by 13.7% over the three year period and the tax liabilities for the £5m-10m bracket decreased in accordance with PBT, from around £140,000 in CY-2 to around £115,000 in CY.

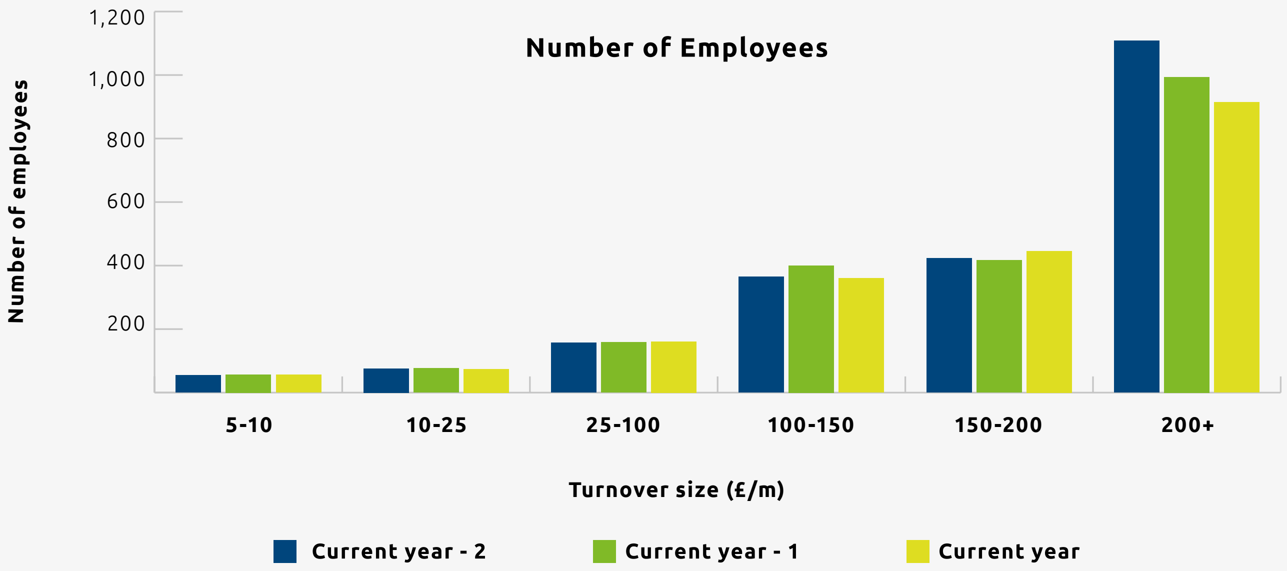
Turnover size and tax charge are, of course, positively correlated. The tax charge for all sized companies except for the £5m-10m companies increased over the three-year period.

Profit Before Tax

Larger companies had a significantly higher Profit Before Tax (PBT), but all sizes showed overall growth in PBT year on year, with only the £100m-150m and £200m+ brackets showing a slight dip in CY-1. The £100m-150m bracket has increased PBT by 78% over the three years.

Larger companies may have lower operating expenses as a percentage of turnover as they have the ability to take advantage of economies of scale. This works well provided they can maintain their order book and margins.

Employment and Remuneration



Number of Employees

The workforces of companies within the smaller turnover brackets remained relatively stable.

The workforces of companies within the smaller turnover brackets remained relatively stable. However, over the three-year period, the £10m-25m, £100m-150m and £200m+ brackets saw employee numbers reduce. The £5m-10m (+1), £25m-100m (+4) and £150m-200m (+23) brackets all increased their employee number count over the period.

On a sector-wide basis across all turnover brackets over the past two years, the construction industry appears to have experienced a fall in the average number of employees per company by 2. These figures seem fairly flat, but they mask the disruption at the higher end of the market.

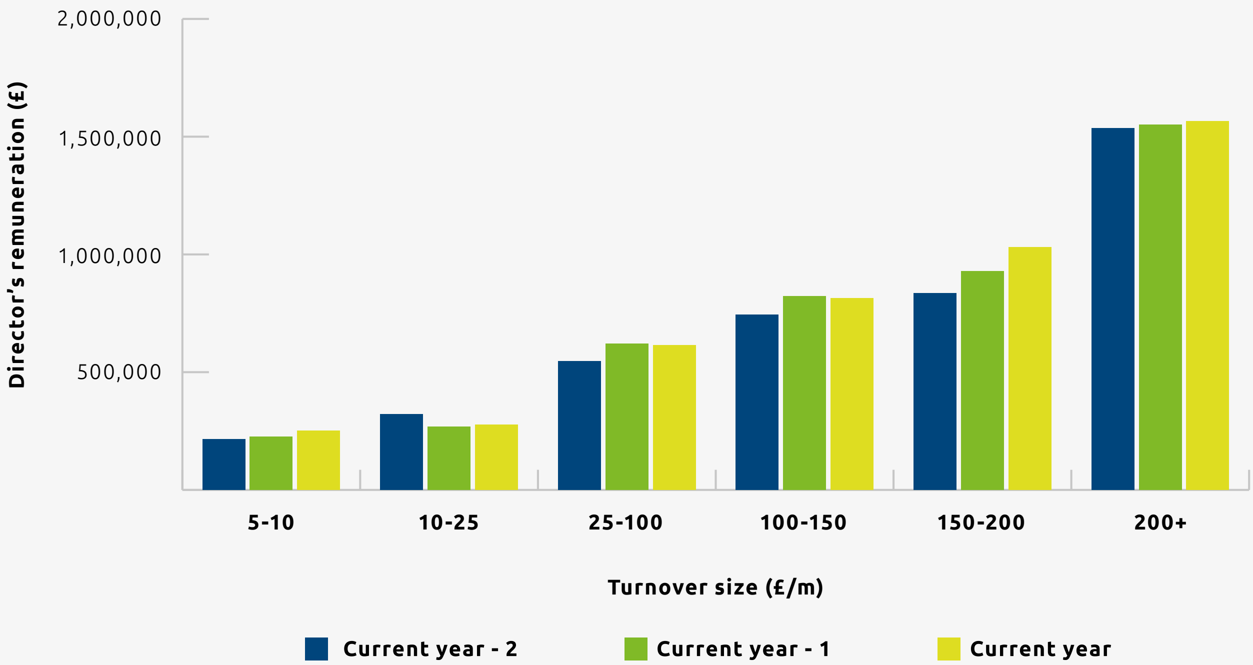
Overall, the employee numbers were steady for companies under the £200m turnover size, but we can see a large decrease in employee numbers for companies over £200m turnover, who are showing significant improvement in pre-tax profit. As turnover has grown, profitability has risen and an increasing number of companies are becoming more efficient. However, this could be to the cost of their subcontractors.

Dividends

The companies within brackets £10m-25m, £25m-100m and £100m-150m increased dividends paid year on year (44% increase, 43% increase and 87% increase respectively over the three year period), with the £200m+ bracket displaying a reduction from CY-2 to CY-1, followed by a 703% increase in dividends from CY-1 to CY. The £150m-200m bracket showed a reduction in dividends paid from CY-1 to CY of 55%.

Furthermore, the £100m-150m bracket showed significantly higher dividend payments for CY in comparison to previous years (73.8% increase compared to a 7.7% increase the year before). Many businesses do not have a formalised dividend policy. Profit extraction can depend on the personal needs of the owners. However, looking at the totals for the three years, there has been a 40% increase overall. There has been a 30.5% increase in pre-tax profits which indicates no real desire to leave more in the business than is considered necessary.

Directors' Remuneration



The **£10m-25m, £25m-100m** and **£100m-150m** brackets showed a slight decline in directors' remuneration.

Highest Paid Director

Largely, there is a clear relationship between directors' remuneration and highest paid director. For the £5m-10m, £100m-150m and £150m-200m turnover brackets, both directors' remuneration and highest paid director figures increased. The £10m-25m bracket however, on average reduced directors' remuneration by 13.6%, but increased pay to the highest paid director by 17.5%. On the other hand, the £25m-100m and £200m+ brackets increased directors' remuneration (by 12.2% and 1.9% respectively), but reduced pay to the highest paid director (by 8.3% and 4.5% respectively). 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. As profitability has been increasing, it has not necessarily flowed through to the highest paid director, which is unlike many other industries.

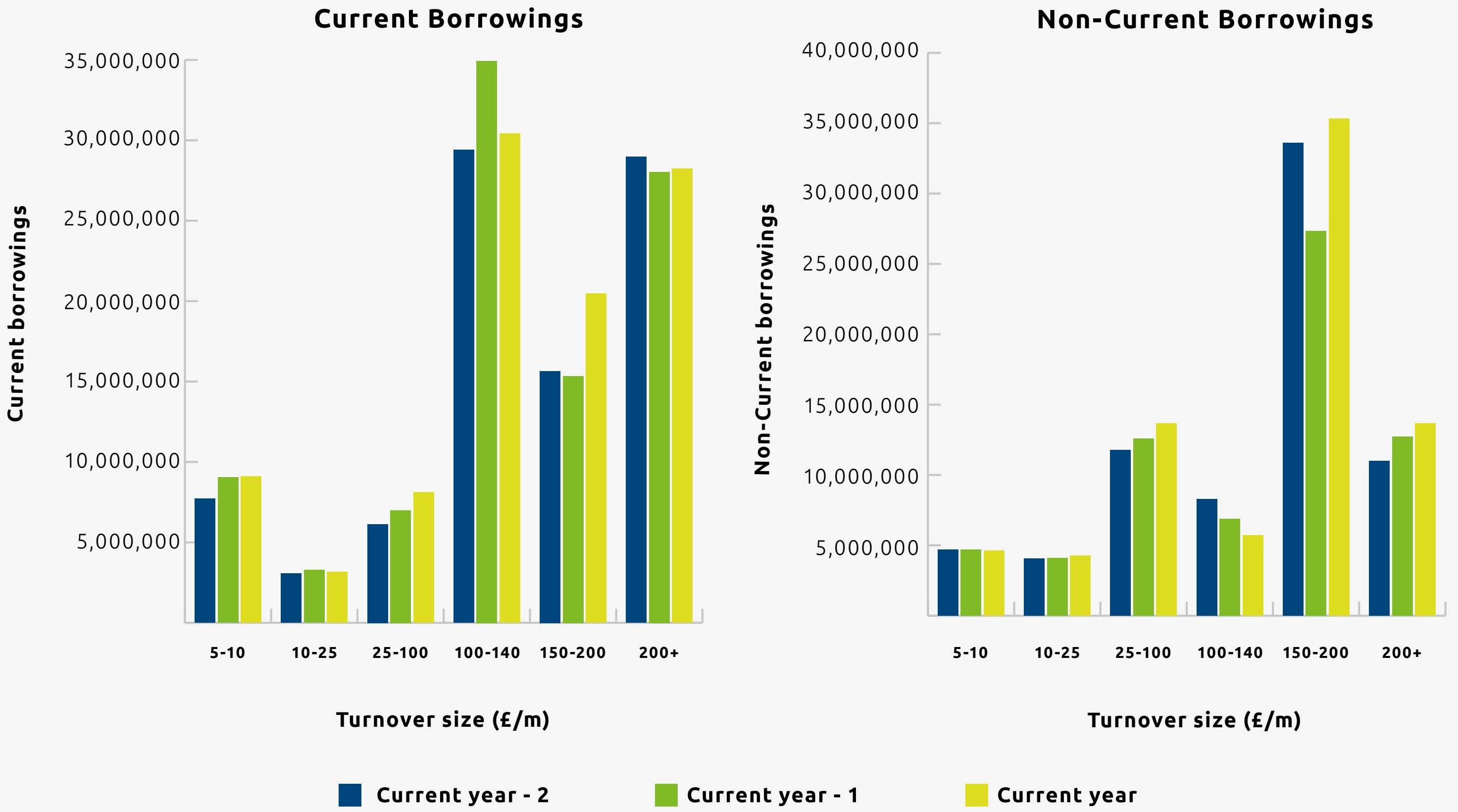
Directors' Remuneration

The £10m-25m, £25m-100m and £100m-150m brackets showed a slight decline in directors' remuneration. This is in contrast to all other turnover brackets, which displayed a steady increase year on year.

Directors remuneration has increased in all bar one turnover bracket (£10m-25m) over the three years. However, unlike profit before tax, the uplift has been modest in real terms.

Business Funding:

Borrowings



The companies within the **£100m-150m** bracket reduced their long-term borrowings year on year.

Current Borrowings

The £100m-150m bracket showed significantly higher current borrowings in comparison to the other turnover brackets. Although they managed to decrease their current borrowings from CY-1 to CY.

The only other bracket that managed to decrease their current borrowings from CY-1 to CY was the £10m-25m bracket.

The increase in current borrowings for the rest of the turnover brackets may be attributed to increased working capital funding, with the largest remaining stable throughout each time period.

Non-Current Borrowings

The £5m-10m, £10m-25m, £25m-100m and £200m+ groups all displayed relatively stable long-term borrowings across the data timeframe. In contrast to this, the companies within the £100m-150m bracket reduced their long-term borrowings year on year. Furthermore, the £10m-25m, £25m-100m, £150m-200m and £200m+ bracket companies increased their long-term borrowings from CY-1 to CY.

Year on year, businesses are increasing their total borrowings except for those in the £100m-150m T/O bracket, who have had significant improvements in PBT and presumably have used those funds to reduce borrowings.

Working Capital

All but the **£5m-10m** and **£200m+** turnover brackets showed an increase in retained earnings year on year.

Working capital remained stable and positive for all turnover brackets. All size brackets increased their year on year working capital except for the £200m+ companies, which saw a slight dip in the CY from CY-1.

The highest growth was seen within the £100m-150m and £150m-200m sized companies. Companies within this bracket on average have low current borrowings and high non-current borrowings, indicating greater emphasis placed upon long-term investment funding.

Retained Earnings

All but the £5m-10m and £200m+ turnover brackets showed an increase in retained earnings year on year. The turnover bracket £100m-150m displayed the largest increase in retained earnings, increasing by 414% over the three years (182% of the growth was experienced from CY-1 to CY).

The £10m-25m bracket increased retained earnings by 51% over the three-year period. The £5m-10m and £200m+ brackets showed a minor reduction in retained earnings from the previous year to CY. There is clear correlation between retained earnings and improvement in working capital.

As there has been improvement in PBT, one would expect to see improved working capital ratios which there is.

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, gross profit margins hold steady (for now at least), and PBT continue to improve. This reflects the growing pressure of the prevailing workload and other supply side factors.
- Surprisingly, growth has been evenly spread across all sizes of business.
- Highest gross profit margin was within £5m-10m T/O and £10m-25m.
- Sales growth year on year is slowing down, reflecting concerns over Brexit no doubt.
- Profitability is helping to improve working capital ratios.
- Profits are being retained, but there is no obvious strategy of increasing retentions above historic levels. When the downturn comes, which it always does, may cause commercial failures.
- London reports a significant down turn in capital expenditure which must be a concern as it suggests companies are not investing in plant and technology.

Future Gazing
The Next 12 Months

The major construction companies (none of which are in our study) will be looking 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. Is this an opportunity for the smaller contractors to step in or will a lack of expertise cause more problems for the industry?

Contractors working in housebuilding, student accommodation and the private rental sector (PRS) should still see growth.

- Companies also referred to their policy of 'sticking to their knitting' by working in markets they are familiar with, with clients they know and in areas they have worked in the past.

- 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 such as expertise and 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. In our sample, many companies talked about internal growth and providing more services to their existing customers.

- Those contractors working in housebuilding, student accommodation and the private rental sector (PRS) should still see growth (if they actually want it) and a consequential increase in profitability.

- 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 continue if not increase once Brexit is resolved, giving a boost to those involved. There may be more opportunity for the bigger players to increase profit margins which they all say they want to do.

- Will Brexit cause contractors to have less labour and therefore capacity, leading to a reduction in turnover?

- Potentially, Brexit (once resolved) may give a boost to the industry as businesses should start to implement decisions that have been put on hold.

- Offsite manufacturing will continue to gain traction, but is unlikely to make the margin impact or improve quantities that many are expecting.

Government funding of infrastructure projects should continue if not increase once Brexit is resolved.

Having the right skill set and being focused on niche markets can produce above average financial reward.

Construction News has just published its annual survey of the top 100 construction companies by turnover. The survey showed a 5.6% increase in combined revenue for the top 10, whereas for our survey we are showing 7.5%. The same companies make an average pre-tax loss of 0.5% as a percentage of turnover, compared to 7.8% in our survey. Indeed only six companies out of the top 100 had exceeded 7.8%

The Construction News survey has Balfour Beatty at number 1 and CJ O'Shea (£133m) at 100. 27 of those companies had a turnover of less than £200m and nine of them were not in the previous year's figures. There are significant turnover and profitability improvements for some companies, showing that having the right skill set and being focused on niche markets can produce above average financial reward that appears unachievable by the larger corporates.

This is one of the reasons certain contractors want to stay in defined comfort boundaries of turnover and areas of work.

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. Carillion has to leave its mark surely.

The key for business owners is to continually appraise their business, in order to maximise the opportunities available and avoid potential pitfalls. Tax can play a significant part in those opportunities.

Below are just some of the potential areas of opportunity we are working with our clients on:

- Research and Development (R&D) tax relief. Where businesses are experimenting with different construction techniques or materials used in the building process, R&D is available and the benefits can be significant, yet many businesses are missing out on tax relief opportunities.
- Capital allowances are available on investment in qualifying plant and machinery. Planning around energy efficient plant and machinery not only has enhanced tax benefits, but also helps emphasise a business' environmental credentials.
- Land remediation relief is available for businesses rectifying contaminated land or derelict buildings. Therefore, if a client is removing asbestos, radon or Japanese knotweed, they could claim tax relief of 150% of the costs incurred.
- Stamp Duty Land Tax planning on non-cash consideration, land swaps and development sites.
- VAT recoverability, particularly on refurbishments and renovations. The new domestic reverse charge regime due in next year could also pose a huge cashflow issue for developers.
- Share incentive and bonus schemes to encourage staff retention can also provide corporation tax relief.
- Construction Industry Scheme (CIS) administration to mitigate any tax leakage or generate rebates.
- Refinancing opportunities whilst the interest rates are low. Furthermore, managing the deductibility of interest following the introduction of the new corporate interest deduction restrictions.
- Mergers and acquisitions advice, including due diligence reviews.
- Re-evaluation of supply chain/sub-contractors to ensure value for money and business continuity.
- Company reorganisations to mitigate risk and protect valuable assets. Tax efficient rationalisations to remove old Special Purpose Vehicles (SPVs) without triggering a tax charge.

The key for business owners is to **continually appraise** their business.

Unfortunately There are Potential Draw Backs:

- Brexit "hangover" may continue to suppress development and speculative builds.
- Starter homes are only available to first time buyers 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.
- Local authorities are becoming increasingly demanding in terms of the amount of affordable housing included in any development, 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 reductions to stimulate demand.
- Exempt stamp duty for over 65's who are downsizing.
- The government needs to make quick decisions on major infrastructure projects, such as Heathrow needing to be fast tracked, support for Crossrail 2, High Speed 2 (HS2), Gatwick and the Trans-Pennines upgrade programme.
- Amending regulations on the retentions held by the main contractor.
- Eradicate late payment practises by applying penalties.
- Tax initiatives to contractor 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.

Regional Analysis
East of England

The East of England is the largest region in the survey in terms of the number of companies, although a significant number of businesses based here are also involved with contracts and developments within London and the wider South East region.

All groups in the region report three years of consecutively increasing turnover.

This means they are generally operating in those regions where there has been significant growth, strong house building and general construction activity in recent years. Whilst the East of England's economy is largely similar to the wider UK, there are some key differences. In particular, the food and drink sector is important to the region, as are financial services and biotechnology, with the latter driving a lot of construction activity, particularly around Cambridge. The energy sector has also become increasingly important, with significant investment in offshore wind farms likely to continue to drive construction activity over the next few years. Therefore, it is no surprise that the survey confirms a largely positive and buoyant overall picture for the region's construction industry.

Sales, Profit and Taxation

Consistent with the above theme, all groups in the region report three years of consecutively increasing turnover. Orders for new work in the region grew strongly in both 2015 and 2016, and in 2016 reached the highest level since 2007. This demand was particularly marked in the industrial sector, with strong rises in activity also seen in both public and private housing. Interestingly, the larger companies in the region saw margins flat or reducing over the period, whereas some companies at the smaller end were able to push margins up.

This probably reflects the mix of work, with more of the larger companies involved with the significant construction and infrastructure projects. Companies at the smaller end were involved with either the type of projects where there are more opportunities to manage margins or housebuilding, which has generally enjoyed more buoyant pricing. Pressure on materials' costs due to Brexit has been a feature in the industry and will have started to have some impact on the numbers reported in our survey as well, particularly on the large infrastructure projects.

Despite margin pressures, most groups showed increased profit before and after tax, partly driven by higher outputs, but also control of overheads. Nearly every group except the smallest reported increased retained earnings and decreases in current debt, a feature common to many sectors, as businesses both remain cautious in the face of uncertainty and retain cash for future investment opportunities.

Growth in the Eastern region should continue over the next two or three years.

Employees, Dividends and Equity

Interestingly, none of the groups reported significant increases in the average number of employees across the three years. This is surprising, both because of the strong output growth reported and because it is inconsistent with statistics from other sources, which suggest increases in construction employment in the region of 2% in 2016 and 7% in 2017.

It is possible that the numbers in our survey are not a true reflection as they won't include self-employed individuals or agency workers. Furthermore, most of the reporting periods captured will only include a small part, if any, of the 2017 calendar year. This highlights one of the limitations of analysing historical data. 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.

Looking Forward to 2018/19

Looking forwards, growth in the Eastern region should continue over the next two or three years, supported by a number of big energy and infrastructure projects. These include investment at Stansted Airport, planned works on the A14, significant mixed development around Cambridge and a number of offshore projects like the £2.5bn East Anglia One development.

Beyond 2020, as many of these projects end, a lot will depend on our economy and, in particular, the outcome of Brexit negotiations. However, there are a number of road projects planned for the early part of the next decade, and potentially other, as yet unconfirmed, larger projects like Sizewell C. The mismatch between strong population growth and supply of housing will continue to drive private housing activity in the region, although affordability could be an issue if the economy falters on the back of Brexit issues, and this could mean less buoyant pricing.

Regional Analysis
London

The companies registered with London postcodes with a turnover up to £200m totalled 258. Many companies will be operating outside this area, so some care must be taken in the interpretation of data in terms of its application to London.

London over the last few years has benefited from an expanding housing market.

London over the last few years has benefited from an expanding housing market, which has been stimulated by the "Help to Buy" scheme. Go back two to three years and housing was very much focused on the £1m+ properties, but Stamp Duty changes brought this to a halt. Now the focus is on properties that are less than £600k, which has encouraged the developers to move out of central London and look at Zones 3-6. Private rented sector (PRS) and student accommodation have also been a recent stimulus in London.

Sales, Profit and Taxation

For any construction company involved in residential development, the last three years have been good. With housing development growing, the Elizabeth Line coming to a conclusion and Tottenham's new ground being developed in a relatively short period of time, there has been a general feel good factor.

Although the top 100 companies, many of which are based in London, have shown little overall growth, our survey of companies with turnover up to £200m is showing continued growth in terms of turnover and profitability. However, those companies in the £120m-200m range have seen a combination of retraction and growth in turnover compared to the previous year. The larger corporates tend to have a mixture of residential and commercial business.

The improvement in profit before tax has come from the larger corporates.

Gross profit margins have remained fairly consistent over the last three years when comparing one year with another. However, the £5m-10m and £100m-150m groups are showing significant improvement in margins.

In January 2018, we had the collapse of Carillion. It is too early to say what the impact has been for the industry as a whole. It is clear that many contractors working for Carillion, in one way or another have taken a hit.

They have primarily lost out due to non-payment and/or the loss of future income streams that they had reason to expect. The number of company failures directly related to the collapse of Carillion seems relatively modest. However, the financial consequences are probably still yet to be seen in published accounts.

Profit and Profit Extraction

The improvement in profit before tax has come from the larger corporates. However, when you look at dividend extraction and directors' remuneration, there is an upward trend in all categories except the largest.

There is a general feeling in the marketplace, in light of Carillion, that profit retention is a prudent concept, whereas no adjustment is evident for the smaller entities.

Overall, the amount paid to the highest paid director has generally fallen. The group of companies in our survey had an average pre-tax profit of 9.7% of turnover. Construction News has just published numbers for the top 100 contractors. They are quoting a pre-tax margin of -0.9% for the top 10 contractors.

Employees

Employee numbers increased and have done so for the last three years.

The concerns over labour shortages have been highlighted regularly, so it is good to see the steady improvement in employed numbers. The shortages are more likely to relate to subcontractors who will have utilised foreign workers to meet demand.

Borrowings

Borrowings have increased for the smaller companies, whereas the larger groups have seen an overall reduction. Working capital has also improved for the larger corporates, with negligible improvements for the smaller companies. There was a marked downward trend in capital expenditure over the three years, which is consistent with the improvement in profitability and working capital. In essence, the smaller companies seem quite prepared to extract the profits earned and potentially facilitate this by increasing borrowings, which must make them vulnerable in any downturn.

The larger companies are not doing this. However they are improving their working capital by holding back capital expenditure which may have ramifications for the future, in terms of ageing plant and lack of investment in new technologies.

Looking Forward to 2018/19

The outlook for London appears to be cautious. The collapse of Carillion should mean there is more work for the survivors and many firms, Balfour Beatty being one, are looking to improve their margins.

However, the industry is culturally fixated on price. If the tier 1 contractors are looking for improved margins, does this mean that tier contractors, i.e. those that are in our analysis, will see pressure to reduce their margins?

Those involved in housing are likely to see their work moved further from the centre, but as the demand is still there, they should be financially sound. Crossrail 2 looks a dim prospect and Heathrow is still very much a talking point rather than action. HSI is definitely gaining traction and will provide opportunities, but Brexit is overhanging the market place which is creating uncertainty.

258
Companies with a turnover up to
£200m

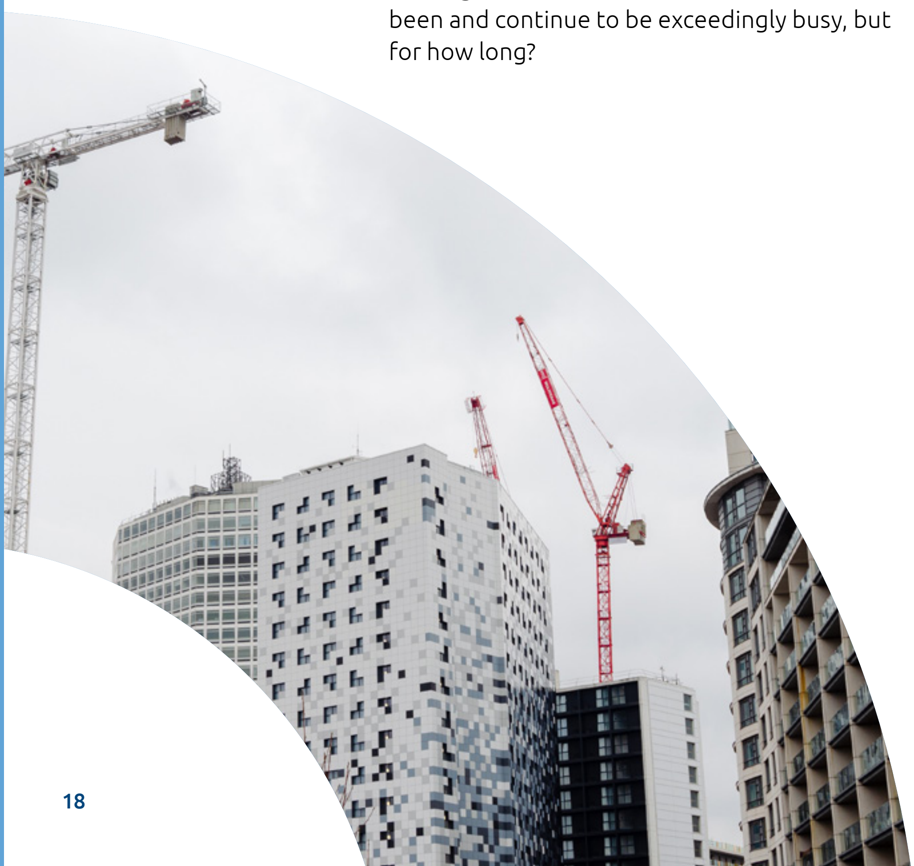
Regional Analysis **Midlands**

The metrics examined in this report are necessarily focussed on financial information published in company accounts. Whilst a useful barometer to illustrate overall trends, by dint of necessity the information will now be almost two years old.

The Midlands region (as is reflected nationally) has seen significant institutional investment in real estate.

However, the MHA Construction & Real Estate Group maintains very close relationships to clients and contacts in the sector and we are able to highlight the following:

- The Midlands region (as is reflected nationally) has seen significant institutional investment in real estate, the highest for several years. Industrial assets have been a clear focus for institutions, as has been borne out by anecdotal evidence from clients.
- In connection with overseas investment, this is dominated by Far Eastern investors who have been attracted to the residential property market by the burgeoning private rented sector (PRS) in cities such as Birmingham and Nottingham. Our construction clients have been and continue to be exceedingly busy, but for how long?
- The retail real estate sector has continued to struggle, with many clients commenting on the volatility caused by high profile Company Voluntary Arrangement's (CVA's) allied to the continued store rationalisation programmes taking place, the latest being Homebase.
- The office market remains strong, with high activity notably in Birmingham evident. Excluding London, Birmingham is among the lowest in terms of office vacancy rates.
- The construction sector remains buoyant, but the impact of Brexit looms large on the horizon, with many projects now being tendered having construction programmes extending beyond April 2019. If there is no Brexit deal, the impacts will become a reality shortly thereafter. Our construction clients remain positive but cautious.



National Trend - Observations

Nationally the sector has seen turnover rise, gross profit margins hold steady (for now at least), but profit before tax is starting to suffer. This reflects the growing pressure of the prevailing workload and other supply side factors. We would expect to see gross margins come under pressure in coming years as the pressures on the sector, both in terms of challenges around delivery and supply pressures increase.

On the other hand, sales growth year on year seems to be slowing down, reflecting concerns over Brexit no doubt. This also accords with the trend in financing, where we can see increases in working capital (for obvious reasons), but a trend of companies of all sizes retaining profits to weather what may be difficult times ahead.

Notwithstanding the Carillion collapse, the underlying figures for the region for the period under review show an underlying resilience built upon years of cautious progression post-recession.

The Midlands Region

The impact of the Carillion collapse continues to reverberate around the country. In the Midlands alone, the Group was responsible for a number of significant projects; the new Midland Metropolitan Hospital, the Paradise redevelopment in Birmingham, plus the £1.4bn joint venture with government on HS2. Whilst new contractors have been found for a number of the projects, the hospital project is now looking for investors after the bank consortium pulled out in the summer.

Notwithstanding the Carillion collapse, the underlying figures for the region for the period under review show an underlying resilience built upon years of cautious progression post-recession.

Many of the largest companies in the region have seen significant growth in the last three years, much of it stimulated by the impact of HS2 on the region. Birmingham, in particular, has seen significant economic activity as a direct result of the project and this undoubtedly is one of the major factors in focus being placed on the region both from home and abroad.

The project has served to attract investment from elsewhere in the country to the Midlands and the results of companies in the construction and real estate space in the region have benefitted accordingly. We have yet to see the true financial impact of Carillion and the retail real estate sector slowdown in the figures, but on the whole, it would appear the region has dealt with the setback well, with little impact on secondary and tertiary suppliers.

Regional Analysis
North East

The size of companies surveyed in the North East were typically those with a turnover between £10m and £100m. There were only two larger companies surveyed with significantly higher turnover. The companies came from a wide range of sectors including house builders, civil contractors, construction services contractors, facilities management providers and property portfolio owners.

Average employee numbers increased by 7% for smaller companies and 14% for medium sized companies.

Sales, Profit and Taxation

Sales were increasing at a faster rate, rising 1.5% from CY-2 to CY-1 and 2.5% from CY-1 to CY. The largest increases were seen in companies with £10m-25m turnover, which grew an average of 4% for their most recent financial year.

Anecdotally, North East companies servicing the London and South East commercial property market have continued to thrive.

This sales growth didn't necessarily translate into improved gross profits, with gross margin falling 1.5% in the £10m-25m bracket in the current year. This was a mixed picture with smaller companies (£5m-10m turnover) and larger ones (£25m-100m turnover), reporting improved margins of around 3%.

Improved gross margins fed through to the bottom line and the number of companies with turnover below £100m and reporting pre-tax losses halved in the current year compared to the two years previous.

UK Government should be pleased too, as its Corporation Tax take more than doubled in the period and yet it has supported smaller SMEs (i.e. below £10m turnover) who saw a fall in average tax payable.

Employees, Dividends and Equity

Average employee numbers increased by 7% for smaller companies and 14% for medium sized companies, but actually fell for the largest companies (e.g. over £25m turnover).

Similarly, average director's remuneration decreased 9% over the three year period. Aside from one exceptional dividend return, dividends paid to shareholders were broadly flat.

Recent investment by private equity shows that the North East has a dynamic construction services sector which is attractive to investors.

Business Funding

Funding for business shows a trend towards longer term funding rather than short term.

Current borrowings decreased by almost 20% over the three year period for companies with turnover below £25m. Average long term borrowings increased by 40% for similar companies.

These increases in long term funding appear to be for investment purposes, as average working capital requirements were broadly static over the three year period.

Looking Forward to 2018/19

Construction companies continue to see a mixed picture for the year ahead.

Recent surveys from the ICAEW Business Confidence Monitor show a negative outlook for construction and property companies nationally, as well as skilled labour shortages which will impact North East companies.

Infrastructure investments planned by The North East Local Enterprise Partnership (LEP) and the Tees Valley LEP will help local and regional firms that win contracts, with the planned growth in housing, road and rail.

Recent investment by private equity shows that the North East has a dynamic construction services sector which is attractive to investors. The most notable deal in 2018 to date was Lloyds Development Capital's £31.8m investment in NBS, a market-leading provider of technology and data services to the architectural, engineering and construction industries.

The £120m North East Fund and other alternative fund providers, such as FW Capital's North East Property Fund, will ensure there is choice for funding expansion for many SMEs.

Regional Analysis **North West**

The North West has a strong construction industry, with a tenth of the companies in our national dataset located here. Eliminating London, it is clear strong demand exists compared to other regions.

The region is consistently behind in pre-tax profits across all brackets.

North West firms have kept pace with others, reporting turnover growth and gross margins in line with national means. However, the region is consistently behind in pre-tax profits across all brackets, but with particularly stark differences in the £100m-150m turnover bracket. Whilst a swathe of this can be attributed to the 'super' profits on offer within London, there is some residual disparity nevertheless.

Average employees across the region have fallen and is now in line with national means across all brackets, maybe pointing towards a conscious efficiency drive in the past year.

Sales, Profit and Taxation

Regional turnover has grown across all brackets in the past year. This growth is stable and consistent except for the smallest companies (£5m-10m), where turnover movement is volatile across our three year data subset.

Gross margins have increased slightly, mirroring our clients' fortunes and, as ever, the larger companies realise almost half the margin of the smallest companies which is linked to the type of work undertaken.

It is particularly striking that the average pre-tax profit of companies in the £25m-100m bracket has nearly caught up with that of the £100m-150m bracket, a theme of the past three years, with the average turnover difference in these brackets of £67.5m delivering an average profit before tax (PBT) disparity of only £420k. It appears a real step up in overhead base in the £100m+ companies is impacting on profits.

Director Remuneration

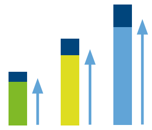
Given this growth, it is natural to see average director remuneration increasing in real terms across all brackets as a reward for the progress in profitability seen across the region.

Dividends and Equity

Given the increase in director remuneration, it is perhaps surprising to note that dividends, as a percentage of profits, have reduced over the three years under review across all brackets except the largest companies, reflecting the need to build balance sheets to cope with any fallout in view of current economic and political uncertainties. As a consequence, net assets are increasing across all brackets.

Employees

Despite a rise in turnover average, employee numbers fell by 6% in the past year. This fall was seen across all brackets except the smallest, where employee numbers were static. The drivers behind this appear to be a mix of greater efficiency, restricted supply of appropriately skilled labour and a switch towards using subcontractors, perhaps motivated through greater employment related legislation in recent years.



All brackets' working capital position has improved over the past year.

Business Funding

All brackets' working capital position has improved over the past year. However, the smaller businesses in the region still have an average negative position of c£9.5m, illustrating how they must manage the cycle carefully and win the right contracts to avoid liquidity problems.

The bracket with the lowest total debt was £10m-25m, indicating these businesses are stable and more mature, but have not yet funded the working capital required to significantly expand further or indeed have no appetite to do so.

Whilst total debt is similar between the £5m-10m and £25m-100m brackets, there is a stark difference between current to non-current debt, at 82:18 in the former and 13:87 in the latter. This indicates the reduced stability and shorter-term strategic view of the smaller bracket, contributing to the earlier working capital observations.

Looking Forward to 2018/19

Given the adage that the construction sector leads the fortunes of the wider economy, it appears the region should be cautiously optimistic. Yes, we all have Brexit to grapple with, but several positives abound.

The North West is a desirable place to set up home - the recent EIU survey has crowned Manchester as the most liveable UK city in the world, whilst Preston, a provincial city to the North, ranks highly in UK affordable and healthy living coefficients. Both cities, surrounding areas and much of the region are seeing a wealth of investment which continues to attract workers.

This significant demand for housing and infrastructure will sustain, meaning there is work to be done and profits to be made. Anecdotally, our clients' sentiments correlate that the North West construction is in reasonable health, despite the uncertain backdrop. Whilst output slipped a little in early 2018, not helped by Carillion's demise stunting local projects such as the Royal Liverpool Hospital, the signs are that it has recovered in the middle of 2018 and point to measured growth in the year ahead.

Regional Analysis
South East

The South East's performance of construction companies has in general been in line with the overall trends identified on a national level, with the larger companies enjoying the benefits of greater profits.

The age-old issue of funding for the smaller construction company appears to remain at both local and national level.

At the national level, it seems that the number of workers employed by the sector has declined. However, at the local level, employment in the sector has increased.

The age-old issue of funding for the smaller construction company appears to remain at both local and national level, whilst large construction companies have increased their working capital positions and improved their ability to win and deliver profitable work in the sector.

Sales, Profit and Taxation

Sales

Over the past three years, the sector in the South East has experienced overall growth of 7.8% in activity terms, although activity has fallen back in the current year with a reduction of 2.4%.

Companies in the sector with a turnover in the range of £10m-25m and £100m-150m have seen the majority of this increase in activity, with an overall increase of 17% and 19.2% respectively across the last three years.

Larger companies with a turnover between £150m-200m have experienced a reduction in activity across the last three years. These companies seem to have experienced some volatility, with an increase in year-on-year activity of 7.7% in CY-1, followed up by an annual reduction of 10.9% in the current year.

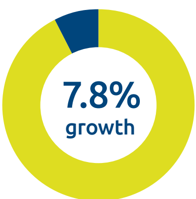
Profit

At gross profit level (sales less costs of sales), the sector has seen an overall increase in profitability. The average gross profit margin in CY-1 was 17.4%, increasing to 17.8% in the current year. This increase shows the sector in the South East is trading better than three years ago. This could be a result of achieving improving contract values, lower costs of materials or labour, or improved efficiencies, perhaps with the use of new technologies.

At net profit level (sales less total costs), the study shows companies as a whole have enjoyed improved profits in the last three years, with an overall 6.2% increase. At one end of the scale, companies in the turnover bracket of £100m-150m have seen a 10% increase in profits, while at the other end, companies in the £25m-100m turnover range have enjoyed an impressive 30% increase over the last three years.

Taxation

Companies with turnovers under £100m all reported similar taxation charges. However, companies with a turnover greater than £100m are reporting significantly lower tax charges on average. While this may raise a few eyebrows initially, upon further review, this is due to regional loss-making companies of national groups.



Over the past three years, the sector in the South East has experienced overall growth of 7.8% in activity terms.

Employees and Directors

Employees

Unsurprisingly, to facilitate the identified increase in activity in the sector, the overall number of staff on the payroll in the region has also increased over the three year period. The majority of this increase was recorded in the current year.

On average, companies in the sector reporting a turnover of £100m-150m have employed a staggering 40% additional staff on their payrolls over the last three years. However, companies reporting a turnover of £150m-200m have actually reported a reduction in employed staff by 7.4%.

Directors' Remuneration

In total, directors' remuneration has increased by 7% over the last three years, although this increase has certainly not been seen by all. Whilst large companies with a turnover in the range of £150m-200m have reduced their employee numbers, these companies have paid an increase of more than 22% in remuneration to their directors. It seems that the larger companies are rewarding their directors for the overall increases in profits being reported.

At the other end of the scale, small companies with turnover up to £10m are reporting an overall reduction in directors' remuneration by 7.5%. Although the smaller companies are reporting an overall increase in profits, directors' remuneration has not followed suit, indicating these companies may be more conservative and protecting company resources for any potential downturn.

Working Capital

Over the three year period, larger companies in the sector have significantly improved their working capital. Companies with a turnover of £100m-£150m improved their working capital by 69%, while companies with higher turnover up to £200m increased theirs by 34.1% over the same three year period. This increase in working capital should allow these larger companies to deliver the larger (possibly government) projects and continue to achieve a desirable level of profit, which should be good news for their stakeholders and the local economy.

However, it is the smaller construction companies that may continue to struggle going forward. They have seen a reduction in their working capital by almost 10% over the last three years. This may be an indication of the minimal funding options that remain available to the smaller construction companies. This funding gap continues to act as a divide between the smaller and larger players in the sector.

Although the smaller companies are reporting an overall increase in profits, directors' remuneration has not followed suit, indicating these companies may be more conservative and protecting company resources for any potential downturn.

Regional Analysis
South West

It has been really interesting this year to be able to get into the nuts and bolts of the financial results of construction sector companies based locally here in the South West and compare those with national trends. In all, we have surveyed 115 companies in our region, and compared these with 1,708 nationally.

> Looking at profit before tax, locally companies have seen some significant improvements over the last three years.

Sales, Profit and Taxation

Whilst nationally, companies have seen good growth at the larger entity end of the survey, and at least steady incomes at the lower and mid-tier, the picture locally is more mixed. Smaller and mid-tier entities, being those companies with turnovers of between £5m and £100m, have seen little growth at all, and at the larger end, sales have even declined, in some cases significantly.

Construction businesses locally have also had a harder time making money from those sales, compared with national averages, although that position is improving. The average gross margin nationally has improved from 18% to 19%, whereas in the South West the improvement has gone from 18.13% up to 19.71%. We're not there yet, but we're on our way. Interestingly, there is something of a correlation between size and margin, but not what you'd think. Our survey broadly indicates that the smaller you are, the better your margins. Of course, this could easily be just to do with the way in which companies record their costs differently in their accounts, but nonetheless, there must be some truth to the fact that biggest is not always best.

Looking at profit before tax, locally companies have seen some significant improvements over the last three years, and this applies to companies of all sizes. Nationally, the picture is much more mixed, with profitability even declining in some parts of the survey. This would indicate that locally businesses have managed to contain their overheads better than their national counterparts.

Businesses will have to find more inventive ways of attracting staff, or invest in other technologies.

Employees, Dividends and Equity

This is borne out to an extent by looking at the average numbers of staff employed by the sector. Locally, except for the £5m-10m bracket, there is a noticeable fall in staffing compared with national averages, particularly at the larger business end of the market. This may well be one of the reasons why overheads have been more successfully curtailed in the South West.

Management remuneration also tends to be lower in the South West than national averages, and this applies pretty much across all sizes of business. This again may have contributed to the better corporate profitability locally. Executive pay is however trending generally upwards, though there is a fair amount of variance year-on-year.

Looking Forward to 2018/19

Looking forward, the big issue on the horizon is of course Brexit. Anecdotally, recruitment is becoming more and more difficult, and this is particularly the case in the South West, across all skill sets and grades within businesses.

Unemployment in the South West is significantly lower than the national average, and this, coupled with the fact that net immigration is also falling, suggests that businesses will have to find more inventive ways of attracting staff, or invest in other technologies in order to reduce their reliance on people altogether. Inevitably, wages will have to rise as the labour markets continue to tighten, which of course, conversely may ultimately lead to a more buoyant housing market.

Regional Analysis **Yorkshire**

The data analysis for Yorkshire construction companies is based on almost 150 companies, with nine out of ten having turnover in the ranges from £5m-100m.

Companies with turnover between **£25m-100m and over £100m** reported the fastest growth.

Sales, Profit and Taxation

Construction sales growth has been strong in recent years. Turnover increased by 6% from CY-2 to CY-1 and 12% from CY-1 to CY. The growth from CY-1 to CY is ahead of the national averages (7%). Those companies with turnover between £25m-100m and over £100m reported the fastest growth, and the sub £10m turnover companies saw a slight decline in sales in the most recent year.

Average gross margin has remained broadly flat over the period. However, those companies with turnover in the £25m-100m range saw the most pressure on margins, with a decrease of nearly 10% from CY-2 to CY.

Fortunately, the increase in sales was able to outweigh the gross margin changes and fed through to the bottom line, with an average increase of 16% from CY–2 to CY-1 and 8% growth from CY-1 to CY. However, it was not an even picture. The very big firms got bigger faster, whilst businesses with sales of £5m-10m saw their profits before tax fall 25% across the three years.

Overall, the profit growth resulted in a doubling of the corporate tax. The effective rate of corporation tax increased from 7% to 11% (below the national average) and may suggest Yorkshire businesses are taking advantage of tax breaks or investing more than their UK counterparts.

Employees, Dividends and Equity

The strong turnover and profit growth was good news for average employment levels, increasing by 5% from CY-2 to CY-1 and 13% from CY-2 to CY. A fall in average profits for smaller companies in the £5m-10m turnover bracket meant that average employee numbers remained flat over the three year period.

Dividends continued strong, with a 17% year on year increase in returns to shareholders. Average director's remuneration remained flat in the current year and there was a fall in the levels of pay reported for the highest paid directors.

Construction remains the largest category of spend for Local Authorities within the Yorkshire and the Humber Region.

Business Funding

Average current borrowings for companies in the ranges from £5m-100m showed no increase in short term borrowings. The £5m-10m bracket showed an 18% increase in long term borrowings, presumably to fund investment. This bucked the trend in Yorkshire as companies in the £10m-25m and £25m-100m ranges fell by around 30%.

Looking Forward to 2018/19

The public sector should continue to boost growth. Construction remains the largest category of spend for Local Authorities within the Yorkshire and the Humber Region, and it benefited from a 158% growth in public housing spending.

Recent large projects, such as the regeneration in Sheffield and the University of Huddersfield, will be followed by the planned investment in The Sheffield Innovation Corridor.

HS2 work is expected to start soon, although the full impact may not be felt for some time with the first trains due to run in 2026.

Such high levels of investment attract attention from national firms and it will be interesting to see how much work is retained in Yorkshire. It would appear that regional contractors have already lost some market share with the latest top ten contractors list dominated by the nationals.

Regional Analysis
Scotland

The Scottish construction sector is under ever increasing pressure to cut costs, meet the rising prices of materials and manage the difficulty in accessing traditional forms of lending, a key challenge for house builders and contractors, in particular.

In Scotland, GP% has increased from **16.54%** to **17.25%.**

There has been significant infrastructure growth over the past five years in Scotland, with the development of large scale road and infrastructure projects. However, Scotland's construction industry continues to face a skills shortage, as workloads are outpacing the availability of qualified professionals. In particular there is a demand for supervisors, logistics and civil engineers.

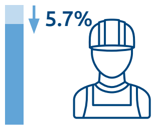
The latest Quarterly National Accounts Scotland show GDP in Scotland grew by 1.3% between the first quarter of 2017 and the first quarter of 2018.

Looking at the overall data, over the last three years turnover nationally has increased by 14.8% on average, with a split of under £100m – 15.2% and over £100m - 11.8%. In comparison, Scotland has shown growth of 8.4% over this period, with a split of under £100m – 4.1% and over £100m - 13.9%.

Gross Profit Margin

Generally, gross profit (GP) margin percentage tends to be much higher for the smaller companies (under £100m) than the larger companies (over £100m). This is seen both in Scotland and at national level. Nationally, GP% has on average grown from 18% to 20%. In Scotland, GP% has increased from 16.54% to 17.25%. Looking at the larger vs smaller split for Scotland, the smaller companies' (under £100m) GP% has increased from 18.01% to 18.63%, whereas the larger companies' GP% has decreased from 8.46% to 7.61%, suggesting that margins are being squeezed for the largest operators in the sector.

This squeeze has not been reflected at national level, the largest companies' GP% has remained stable over the three years, whereas the smaller companies have increased GP% by 1%. Raw material costs, such as timber, have been rising quite significantly over the last 12–18 months which could be impacting margins, along with ever increasing staff costs which the largest companies are not managing to pass on to the end customer.



Scotland is following the national trend, with workforces **decreasing by 5.7% on average.**

Profit Before Tax

Nationally, Profit Before Tax (PBT) has increased by 30.5% on average, with the largest companies (over £100m) experiencing the highest growth. Within Scotland, these "smallest" companies (under £100m) are showing a 19.2% decrease in PBT, so appear to be struggling more compared to companies their size nationally. However, it should be noted that the smallest group of companies (£5m-10m) have seen a 66.6% reduction in PBT over the last three years, compared to a 5.3% increase nationally.

For companies with a turnover between £25m-200m, PBT has decreased by 9.2% over the three year period. In the face of decreasing margins (compared to the national average), it is not a surprise that the large companies (over £100m) have suffered a decrease in profitability assuming their overhead base has not significantly changed. It would appear that overall, controlling overheads in relation to margins is proving difficult.

Employees

Nationally, employee numbers have decreased by 1.6%, with the largest companies (over £200m) reducing their workforce by 17.5%. The smallest companies (under £100m) have increased their workforce by 1.4% (4 employees on average). Overall, Scotland is following the national trend, with workforces decreasing by 5.7% on average.

The largest companies are again decreasing their workforce, although so too are the smallest companies (under £100m) who are bucking the national average and showing a 5.7% (8 employees on average) decrease in their workforce. This decrease is concerning given the future staffing commitments for the industry. Although, the data does not make it clear whether these decreases are at an operation or administrative level.

These decreasing employee figures support data provided by Scottish Engineering in their 2018 Q1 report, although their most recent Q2 June report reveals a rise in employee numbers across small and medium sized companies, with large companies still reporting a decrease.

Like many sectors of Scotland's economy, there are challenges, but many of these challenges are out of the control of the sector, particularly as the global economic picture remains uncertain. The widely acknowledged skills gap is a key barrier to growth and could impact the Scottish Government's target of building 50,000 affordable homes in five years. In addition, there will be competing demands for skills across the UK, which could also undermine the construction sector's opportunity to take advantage of technological developments.

Regional Analysis
Wales

Wales' construction industry plays a vital role in delivering a vibrant economy and a quality environment. In Wales there are approximately 13,000 companies involved within this sector, employing Circa 112,000 people. The data analysis for Wales is based on over 50 construction companies, with the majority having turnover in the ranges from £5m-100m.

Companies in the **£100m-150m** turnover bracket displayed the highest overall growth.

Sales

Output in the construction sector in Wales remains at a high level. As with the national survey, smaller companies have displayed the greatest stability in turnover. Companies in the £100m-150m turnover bracket displayed the highest overall growth. Companies in the £200m+ turnover bracket have generally experienced declining revenues

Profit Before Tax

Large companies in the £200m+ turnover bracket showed the greatest volatility in profits. Companies in the £5m-10m and £100m-150m turnover brackets were the only companies to show growth in profits year on year.

Gross Profit Margin

As with the national survey, smaller companies in the £5m-10m turnover bracket had the highest gross profit margins; the margins achieved were higher than the national average at circa 26.5% in Wales versus 25.3% nationally. The lowest gross profit margins were seen in the £100m-150m and £200m+ turnover brackets, with an average margin of 7.3% and 5.5% respectively over the past three years. The impact of intense competition and rising material costs has had the impact of driving margins down.

Employees

Employee levels in the £200m+ turnover bracket have been in steady decline. Employee levels in the £25m-100m turnover bracket showed the greatest stability.

Dividends

Dividend levels have generally been in decline when tracked over a three year period. Companies in the £25m-100m turnover bracket encountered a consistent year on year reduction in dividend payments.

Managing working capital and cash has become increasingly challenging.

Business Funding and Working Capital

Over the past year, current borrowings have generally increased. Companies in the £200m+ turnover bracket encountered the largest increase in current borrowings when compared with other turnover brackets. The increase in short term borrowings is symptomatic of working capital pressures facing construction companies in Wales.

Managing working capital and cash has become increasingly challenging. Customer receipts tend to be infrequent and are often delayed, whereas project costs have to be settled on a frequent/regular basis to cover ongoing costs. Managing working capital frequently results in creditor payments being stretched pending receipt of payments from customers. The pressure from suppliers to be paid on-time (and frequently early) and customers wanting to preserve cash within their own businesses has stretched working capital requirements.

Outlook

The growth rate of the construction sector in Wales is predicted to be more than triple that of the UK as a whole this year. Over the next five years, with projects such as the Wylfa Newydd nuclear power station in North Wales and the next phase of the South Wales Metro with electrification of the Valley Lines, the sector is predicted to create 12,250 new jobs.

Research from Construction Industry Training Board (CITB) estimates the sector in Wales will achieve an annual growth rate of 4.6% compared to a UK average of 1.3%. Other areas providing a boost to the sector in Wales include both the private and public housing sectors, with the Welsh Government setting a target of 20,000 new affordable homes by 2020/21.

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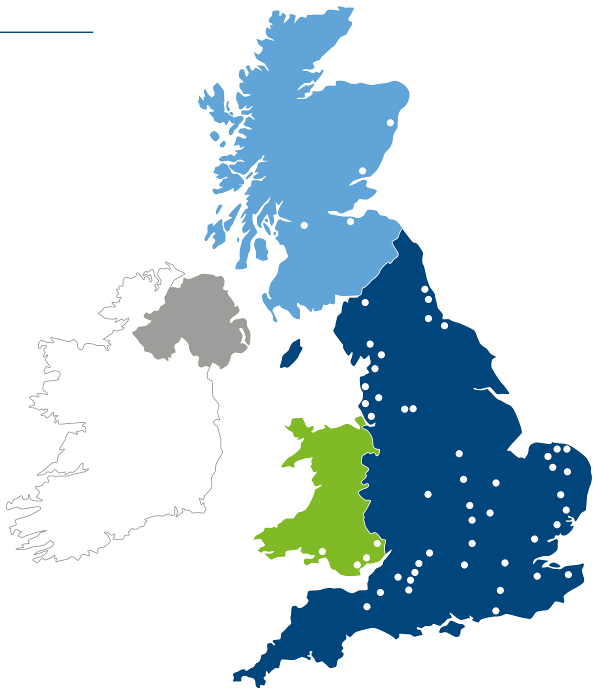

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