COVID-19 INSIGHT

NAVIGATING A NEW WORLD

How Covid-19 will impact construction finances

Coronavirus is causing a severe economic shock to many parts of the economy, whilst it may not appear apparent, the impact on the construction industry will be significant and likely to have major structural effects on the sector's supply chain.

The UK's Office for Budget Responsibility (OBR) is charged with providing independent forecasts and analysis to help inform business and policymakers. Their Coronavirus scenario suggests that construction might see a 70% reduction in output for Q2 of this year causing significant cash flow issues for those without significant cash reserves.

The construction sector comprises of many sub sectors which causes additional challenges and interdependencies. The latest data shows there are 325,000 construction companies in the UK, incredibly only a mere 250 of these are not classed as SMEs.

The sector is divided into several sub-sectors comprised of housing, private and public buildings, infrastructure, and repair and maintenance. It has become more apparent during the Covid-19 pandemic that the sector operates as an interdependent eco-system reliant on all of its constituent parts functioning.

Analysis carried out for the UK's Department for Business, Energy and Industrial Strategy showed that for a 'typical' large building project the main contractor is on average responsible for managing around 70 sub-contracts of which a large proportion are valued at under £50,000 or less. When looking outside of the South East subcontract size may be even smaller with examples in the research of projects where 70% of sub-contracts were below £10,000.

An additional challenge is caused by the 'break-even' point – where operating is only worthwhile for manufacturing plants and production lines above a certain volume. Many supplies used on commercial construction sites are the same products which flow through to consumers. Households are not progressing or starting normal renovation and maintenance work this will cause demand to drop below the break-even point of operation.

We have created an indicative model to assess the financial impact on construction using data from the OBR Coronavirus impact scenario, Office for National Statistics and the Institution of Civil Engineers and approximating that output is a good indicator of turnover in construction due to low margins.

Using these assumptions our modelling suggests that due to the COVID-19 lockdown measures, and associated economic fallout, UK construction firms will see a negative impact on turnover of £29bn in Q2 of 2020.

Assuming 70% of public or private building work and infrastructure output by value flows through the UK's Tier 1/General Contractors and the remaining 30% of work is split equally between those categorised as Tier 3 or Tier 4+ suppliers, the impact throughout the industry would be as follows (note the figures do not equal £29bn due to 'recycled' money flowing through the tiers of suppliers):

	Negative cash flow impact for Q2 2020
Tier 1/General Contractors	£20bn
Tier 2 suppliers	£16bn
Tier 3 suppliers	£15bn
Tier 4+ suppliers	£15bn

Although the Government has said that all public bodies, including councils, schools and government departments should keep paying suppliers – even if services and projects have been scaled back or paused – this would only reduce impacts by 25% given the share of work the public sector accounts for.

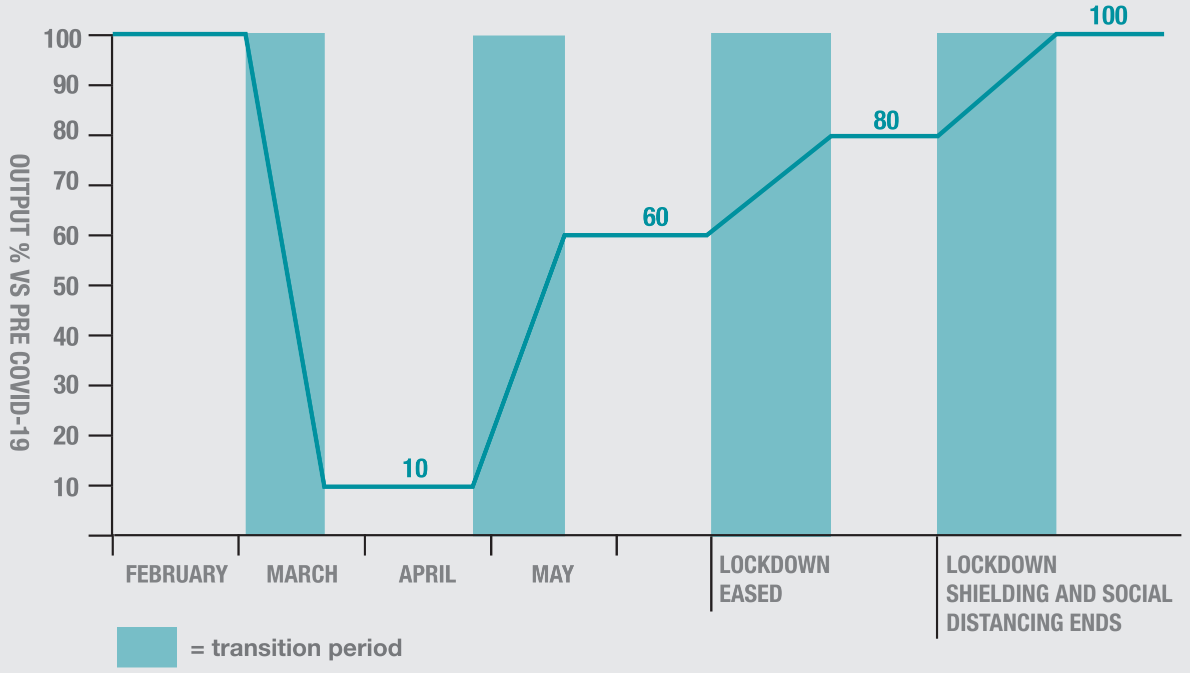
Smaller companies without cash reserves and strong balance sheets will face a significant challenge from the perspective of cash flow and their ability to access and apply for the relevant government support packages.

Worryingly, initial work done by the ICE indicates that around a third of construction businesses have had their COVID-19 Business Interruption Loan applications rejected and that 4 in 10 businesses were making their applications for meet very short-term funding needs and until the furlough scheme payments are made. This would indicate many businesses are in or anticipating severe financial distress and potentially a reluctance of lenders to work constructively with the industry.

It is unlikely that the full impacts of reduced cash flow through supply chains will materialise until later in the year. As businesses re-commence works on their sites, under the existing contract terms, they won't receive any cash for around 50–60 days. At the same time, suppliers will be increasing labour and material purchases as they look to increase output each month. Given the nature of billing in the construction sector, there is a possible 'time bomb' on the horizon for SME businesses which is likely appear from Q3 2020. This will only be exacerbated by clients deciding to withhold or delay payments and the expiration of the Government's job retention scheme.

We suggest that over the coming months the industry will transition through different phases (Figure 1), each of which will impact levels of output, the amount of work delivered and cash flow.

FIG 1: COVID-19 IMPACT ON CONSTRUCTION OUTPUT



Phase 1: shutdown – manufacturers closed their facilities and furloughed their workforce and many construction sites ceased to operate as construction businesses established new ways of working that respected social distancing measures.

Phase 2: developing new working patterns – after the shutdown phase, companies managed to develop new ways of working and many large construction projects restarted perhaps with a reduced on-site workforce due to health concerns and reduced public transport services. Many residential projects being delivered by house builders are only just re-starting.

Phase 3: lockdown eased – as lockdown measures are relaxed and people are encouraged to move towards their normal lives a larger number of workers will re-enter the workforce and there may be potential for upscaling on-site workforces again.

Phase 4: lockdown shielding and social distancing end - given the ageing nature of the construction industry workforce a higher than average proportion of workers will have received letters from the Government advising them to isolate themselves. Only when these practices are not advised, social distancing is completely lifted, and sentiment rises will output increase back to pre-COVID-19 levels.

The length of the transitions between each of the phases is dependent on the effectiveness of 'return to work' planning and the share of the workforce who are absent due to illness and the impact of that on productivity.

Our recommendations

1. To ensure that supply chains remain intact with the capacity to deliver, all businesses should try and work constructively and openly with their supply chain to address potential cash flow issues up front. Invoices must be paid on time and private businesses should match the commitment made by the public sector. If clients start to withhold or delay payments it could cause a 'domino effect' across the whole industry. Refer to Government and CLC guidlines.

   GOVERNMENT GUIDELINES

   CLC GUIDELINES

2. Businesses of all types should use the GOV.UK online service which helps identify the most appropriate support schemes for different types of business and approach their banking partners to understand facilities available to them. Trade bodies such as Build UK may also be able to offer advice and practical support.

   BUSINESS SUPPORT FINDER

3. Clients and their suppliers should work collaboratively to maximise the amount of work that can be done now whilst respecting the government's guidance and plan ahead to see how schemes could be accelerated to make up lost ground once lockdown measures are eased.

4. Prof Richard Rumelt talks about "chain-linked systems". Construction is a chain-linked system due to its structure and complexity of its many supply-chains. This means that the system is limited by its weakest link. Large projects need to stress-test and review any possible weak link or vulnerable supply chain partners and develop mitigation strategies.

5. We should have empathy with all those we do business with. It's only by behaving more collaboratively will we reduce the economic damage and have a healthy construction industry that can help our country recover. The demise of Carillion demonstrated the significant broader economic and societal impacts of what happens when a large construction business can no longer meet its obligations.