Construction update Autumn 2022

Sector overview

A slowdown in construction activity amidst supply chain disruption and baked in cost inflation is impacting the construction sector. Construction related corporate insolvencies continue to increase in the SME market but there are signs of contagion with more sophisticated corporates starting to feel the pain. A summer softening in demand has cooled inflation rates, but from dizzy heights; the current cost of materials and labour still represents a challenge for most. Sizeable covid related debt levels exist in the market with refinancing on suitable debt structures key to the survival for many. The demand curve for construction may ultimately flatten with build appetite still evident but the headwinds that this sector faces persist.

Economic Data

> **ONS Data:** Construction output declined 0.8% in July, following a 1.4% decline in June.

> **S&P Global/ CIPS UK:** A score of 49.2 was posted in August 2022.

> **Gov UK:** 12-months ending June 2022 saw 3,665 construction related insolvencies in England and Wales which represents 19% of all corporate cases captured – construction being the most impacted industry.

> **CPA:** Forecasted construction growth recently downgraded to 2.5% from 5.2% for 2022.

Made possible QBE

Strengths

> **Housebuilders:** National housebuilders including Vistry Group, Redrow PLC and Barratt Developments all released positive trading results in Q3. Fire safety provisions continue to filter through, with footnotes touching on expected economic headwinds, but the overall outlook for this sector is a stable one.

> **UK Infrastructure:** Still expected to be a core driver of growth in 2022 with an 8.5% rise in output forecast for 2022 and 3.8% increase in 2023 (CPA). Long-term pipelines in regulated sectors such as roads, rail, water, and electricity will support contractors boosted by key projects such as Hinkley Point C and HS2.

Challenges

> **Fixed price contracts:** Anecdotally QBE is receiving an increased level of risk feedback relating to loss making fixed price contracts as contractors grapple with price volatility and supply chain issues. Cost mitigating clauses such as price escalators are the focus when negotiating new construction contracts.

> **Hyperinflation turns to stagflation:** The material price index indicated that the cost of all construction work was up 24.1% for the 12-months through to July 2022 (ONS). A moderate slowdown in summer demand has softened construction inflation rates yet labour, raw material and energy cost increases are thought to be on the horizon. In the wake of slowing sector growth, lower new order levels and a drop off in job creation rates, hyperinflation looks set to evolve into stagflation.

> **Construction industry default rates on covid loans:** With the pandemic in the rear-view mirror, and the 12-month grace period on loan repayments ending, attention now turns to the repayment of covid related corporate debt. Over 1.6m of covid related debt facilities totalling £77bn has been drawn by UK businesses. 97k CBILS related loans (designed for SMEs) produced an average default rate of 2% in June. Construction businesses had the highest default rate of 2.5%.

Underwriting Approach

> **Stable underwriting stance retained for construction with closer emphasis on smaller to mid-sized contractors as insolvencies move up through the supply chain:** case-by-case underwriting approach with each business to be assessed on their own individual financial merits.

> **Information remains vital:** Up to date financials, order books, bank forms and covenant visibility is crucial when assessing challenging credit risks in construction.

Notable Insolvency Events

> **P.D.R. Construction Ltd** (January) – Contractor, £83m t/o

> **Beaumont Morgan Developments Ltd** (January) – Contractor, £47m t/o

> **Midas Group Ltd** (January) – Contractor, £292m t/o

> **Kace Holdings Ltd** (February) – Facade specialist, £14m t/o

> **Mulbury Homes Ltd** (February) – Property developer, £38m t/o

> **Caledonian Modular** (March) – Contractor/ Modular specialist, £45m t/o

> **Roadbridge Holdings Ltd** (March) – Civil Engineering Contractor, €271m t/o

> **Kershaw Group Holdings Ltd** (April) – M&E contractor, £28m t/o

> **Urban Splash House Holdings Ltd** (May) – Modular Housebuilder, £10m t/o

> **NWP Electrical & Mechanical** (July) – M&E contractor, £38m t/o

> **Edge DBS Ltd** (July) - M&E contractor, £21m t/o

> **P&R Morson & Company Ltd** (July) - M&E contractor, £15m t/o

> **Brymor Group Ltd** (July) – Contractor, £76m t/o

> **Greswolde Construction Ltd** (July) – Contractor, £19m t/o

> **Haydon Mechanical & Electrical Ltd** (August) – M&E contractor, £38m t/o (CVA)

> **Harris CM Ltd** (August) – Contractor, £27m t/o

> **Speedclad Ltd** (August) – Façade contractor, £19m t/o

> **W.Stirland Ltd** (August) – Contractor, £27m t/o

> **Avonside Roofing** (September) – Roofing contractor, £48m t/o

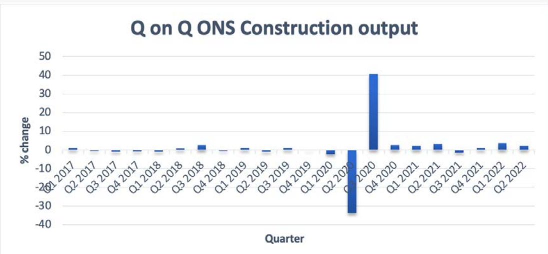
Construction update

Q2 2022 ONS construction output

Despite a monthly fall in June, Q2 2022 quarterly construction output rose by 2.3% compared to Q1 2022. An increase in private housing (3.9%), infrastructure new work (3.9%) and private industrial new work (15,8%) were the key contributors to this quarter's growth. Total construction new orders did however decrease by 10.4% quarter-on-quarter - New order levels remain above pre-pandemic levels, but this represents the second consecutive fall following the 2.6% decline noted in Q1 2022.

The 12-month annualised rate of construction output increased by 9.6% through to June 2022. Feedback from industry related think tanks continue with the narrative that cost inflation on core products such as concrete, bricks, plaster, and tiles, combined with higher fuel and tax increases remain challenging for the industry.

July 2022 monthly ONS release shows a 0.8% decrease in construction output compared to the previous month indicating that lower new order demand levels are starting to filter through.



Source: Data from ONS

August construction PMI

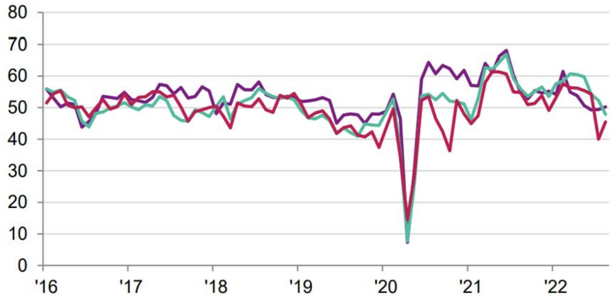
The S&P Global/CIPS UK Construction PMI shows a second consecutive dip in perceived construction activity for the month of August. The Total Activity Index score was 49.2, up modestly from 48.9 in July but below the all-important 50.0 no-change mark.

The fall in activity seems to have relieved some supply chain pressures with average lead times lengthening to the least extent over the last 36-months; the same can be said for inflationary pressures. Activity in the civil engineering and commercial sub-sectors declined, but on a more upbeat note, housebuilding activity returned to growth for the first time in 3 months.

Reports of clients refraining from committing to new orders amid cost pressures and concerns over a wider economic downturn were recorded suggesting a drop in new order confidence. This appears to have fed into lower job creation rates in the industry which are the lowest since March 2021 - employment rates remain solid in the industry, but lower job creation rates suggest a potential slowdown in future recruiting activity.

Construction Total Activity Index

sa, >50 = growth since previous month



Source for graph: https://www.pmi.spglobal.com/Public/Home/PressRelease/7b47674e3c3249dda788ec1e76971f7d

Contacts

Dave Murray
Risk Underwriting Manager
Trade Credit (Heavy Industries)
Credit & Surety Europe
QBE European Operations
email dave.murray@uk.qbe.com

QBE European Operations

30 Fenchurch Street
London EC3M 3BD
tel +44 (0)20 7105 4000
QBEeurope.com

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