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Phoenix Companies and Personal Liability
Institutions Need to Become a Bit More Analytical
Agricultural and Rural Land and Estates Survey 2013
Seeking Answers with NAC
Time For Some Blue Sky Cloud Thinking

A large, horizontal silhouette of a construction site at sunset. The sky is a warm, golden-yellow color. In the foreground, several construction workers are silhouetted against the bright background, working on a structure. A large tower crane is the central focus, with its long jib extending across the frame. Other cranes and structural elements are visible in the background.

**Are there Green Shoots of Recovery for the UK
Construction Industry?**

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Cover Feature



Are There Green Shoots of Recovery for the UK Construction Industry and if so, is the Surety Market in a Position to Support?

With a devastating 17% drop in activity and struggling to operate in such a volatile environment, there appears to be very few success stories for the UK Construction Industry leading to two prevailing schools of thought; one is that the continued crisis in confidence represents a continuation of a long lasting downward spiral with no safe haven to hide in; the other is that there is an emerging pattern of success, particularly in London, and that the UK Surety market still has a very positive part to play in securing a foothold for these green shoots of recovery. This paper seeks to address both arguments by detailing what has happened and what the future may hold going forward.

In ANALYSIS ...

Time For Some Blue Sky Cloud Thinking

Cloud – is a word that is become synonymous with business IT. For the last year, we have witnessed a new phenomenon as companies and providers have clambered over themselves to become 'Cloud pioneers'. In this article, the author discusses how with Cloud-based IT and storage systems becoming an increasingly important part of our everyday business practices, are they safe and are they really meeting the needs of business?

Analysis

Are There Green Shoots of Recovery for the UK Construction Industry and if so, is the Surety Market in a Position to Support?

Paul Rowland



Paul Rowland
Oval Insurance Broking

Biography

During 20 years broking and underwriting on behalf of some of the industry's leading practitioners, Paul Christopher Rowland BA (Hons) has gained extensive experience in reviewing and placing a diverse range of transactions on behalf of UK and International Corporate clients to manage their Commercial, Financial, Liability, Trade Credit, Political Risk, Surety and receivables management programmes through the Lloyd's of London and Corporate insurance markets.

*Paul has regularly written for Business Money, **CREDIT CONTROL JOURNAL** and **ASSET & RISK REVIEW** and has contributed to the Insurance Times and Post Weekly.*

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Abstract

With a devastating 17% drop in activity and struggling to operate in such a volatile environment, there appears to be very few success stories for the UK Construction Industry leading to two prevailing schools of thought; one is that the continued crisis in confidence represents a continuation of a long lasting downward spiral with no safe haven to hide in; the other is that there is an emerging pattern of success, particularly in London, and that the UK Surety market still has a very positive part to play in securing a foothold for these green shoots of recovery.

This paper seeks to address both arguments by detailing what has happened and what the future may hold going forward.

Introduction

Dr Samuel Johnson was commissioned by a group of booksellers to compile a dictionary in 1746 and nine years later he presented them with his completed life's work of 2,300 pages with 42,773 definitions and 114,300 illustrative quotations, with a total word count of over 3,000,000 and thus longer than the

Bible. Of all the hundreds of words that have slipped away from common usage, my favourite combination is Flagitious (*adj*) Fopdoodle (*n*): villainous fool.

In attempting to persuade such learned readers of **CREDIT CONTROL JOURNAL and ASSET & RISK REVIEW** that there are indeed green shoots of recovery for the UK Construction industry, perhaps I will indeed make myself deserving of such an unwanted title! However, bear with me as I sieve through the facts, add my take on matters and perhaps indeed I will turn your opinion that this article is indeed worthy of your own deliberations.

The UK Construction industry in some quarters of the financial press is so maligned that it has the smell of a fish not in the best of health lying on a fishmonger's slab; hardly surprising given the external economic headwinds that continue to cause uncertainty for its financial viability and contract certainty.

After a three-year decline across 2009–2012, with a devastating 17% drop in activity over that period, the UK Construction industry continues to be affected by significant difficulties in performance, pricing and supply.

Within the UK Construction industry, ten companies on average have failed on a daily basis over the last three years, with major failures including MJN Colston, John Doyle and Airedale Mechanical & Electrical. There continues to be a large number of payment incidents and most industry experts predict the outlook for 2013 as being “difficult” because of restrictions on both public and private spending, a drop in contract values and less volume in the marketplace.

The Department for Local Government and Communities recently reported that Q1 2013 has delivered a 14.5% drop in residential building, against the same period last year. Margins have been eroded as competing businesses reduce their tender prices in an attempt to win contracts and maintain turnover levels. This is evidenced by larger market players “dropping down” to bid for contracts that would have previously been seen as too small in better times.

Many Tier 1 Contractors will continue to insist upon longer payment terms from their suppliers beyond the industry average of 45–60 days. Government “pressure releasing” legislation and repeated calls by industry leaders will fall on deaf ears, because there is no sign that the UK Construction industry has the appetite or capacity to improve payments within its supply chain.

As this trend continues, smaller companies (Sub-Contractors) will become rooted in an increasingly perilous financial position; enforced payment terms beyond 60 and even 90 days means that they have in effect become a direct working capital funder for the larger and more powerful construction companies.

The economic uncertainty continues to fuel and intensify the pressure on the supply chain, creating further payment delays. The UK Construction industry

still maintains a higher level of insolvency than other trade sectors because of severe pricing and lack of cash flow; between Q3 2010 and Q4 2012 nearly 6,200 insolvencies have been registered across construction and civil engineering.

There have also been notable failures in the mechanical and electrical Sub-Contracting sectors, where margins are even more cut-throat and all work appears to be taken on at break-even prices simply to generate and sustain turnover

The UK Construction industry has been decimated over the previous decade and from amongst the surviving participants the underwriting market is expecting more insolvencies towards the end of 2013 Q2 and into Q3. The reason being is that each calendar year has always been traditionally difficult for the UK Construction industry and even with healthy order books and solid contracts, many more construction companies will continue to lose their fight for survival because they are not able to access cash when they need it.

During my Fathers' career in the City at Cowbotham's and latterly Liberty Mutual, I remember him as being a highly respected, robust and dynamic professional, with the resilience and fighting prowess of a middle weight boxer and a laugh like a squadron of Wellington's cavalry troopers, charging over a tin bridge in pursuit of Napoleon after Waterloo.

One of his many pearls of wisdom that remain with me to this day is: "You cannot go by what the press says when they are having a go at somebody or a beleaguered industry; it is like Shakespeare, sounds good but does not mean a thing!"

So it is that I do not believe all of the doom and gloom!

Although the value and volume of new work dropped for a consecutive 11th month, Markit's closely watched business survey, the Purchasing Manager's Index (PMI) rose to its highest level in six months for Constructors to 49.4 in the week commencing 29 April 2013.

Deloitte has released the results of its London Office Crane Survey that evidenced an 8% increase in office construction across the past six months, with almost ten million square feet under current activity with a more than three fold increase in comparison to the low of three million less than three years ago in 2010.

There is a pair of eye catching buildings that have been going up since 2007 and are soon to compete with "The Shard" as the structure to dominate the City of London's skyline when they are completed in 2014, British Land's "The Cheesegrater" on Leadenhall Street and Land Securities' "The Walkie Talkie" on Fenchurch Street. On a smaller scale, but no less esthetically pleasing is

Great Portland Estate's New Fetter Lane offices due for completion in 2015 and full occupation by the law firm Bird & Bird.

A little journey down Old Father Thames would bring you to the currently derelict, unfashionable and unloved 40 acres Convoys Wharf site at Deptford. However, there are plans afoot to invest £1 billion into a Scheme led by Hutchison Whampoa's urban designer Sir Terry Farrell, to commence a decade long construction programme in 2014 and transform the area into a high end residential hub of 3,500 homes, three high rise towers up to 4 storeys tall, three new parks and a cultural centre, all with access to the waterfront.

I believe that there is a sense of renewed confidence occasioned by improving weather to allow catch up work across the summer after the appalling weather in January and February prevented consistent and quality time on site. In addition, total construction output has been bolstered by increasing levels of residential housing and a number of big ticket infrastructure projects strengthening an otherwise weak public sector order inflow.

The improvement in the PMI score should be seen as clear evidence that the industry's recent decline is coming to an end and that construction will lessen its negative "drag" influence on the UK's GDP across Q2 and Q3 2013.

It is estimated that within London alone there are 177,000 new housing units, with planning permission that developers are land banking as they stall upon executing. There is an opportunity to bring these units onto the open market should Mayor Boris Johnson garner support from the Government appointed planning officials to accept that it is in the public interest to push through a proposed large scale programme of complicated and expensive Compulsory Purchase Order legislation.

There remain strong businesses in the industry who have focused the necessary cost cutting and efficiency improvements to cope with the problems in the marketplace. In doing so, I believe that they will be able to defend themselves from the vulnerability of both macro and micro economic factors and are to be applauded for taking the difficult steps required to control their working capital and thus secure successful projects going forward.

Despite the fierce competition, the UK Construction industry still shows signs of recovery and getting back on its feet if reports coming from three of the most high profile domestic groups can be seen to accurately reflect the current environment.

The FTSE 250 listed company Balfour Beatty recently commented that they had endured a 23% drop in Q1 revenues for their construction business. However, the firm is hopeful of breaking even by the end of the year as they pursue opportunities in other countries and sectors, while benefiting from a domestic strategic programme of cost efficiency initiatives.

Meanwhile, the UK's second largest house builder, Barratt Developments, has reported that the Government's homebuyer mortgage initiative, "Help to Buy" has created the most positive housing market in five years, even though the mortgage guarantees scheme does not come into effect until 2014. On the back of the very positive impact of this Government intervention and the resulting 29% increase in last year's private forward sales to a staggering value of £1 billion, the group is hoping to be debt free by 2015, as it cut £600 million away between June 2012–June 2013, to leave a balance of £100 million.

The Royal Chartered Institute of Chartered Surveyors' (RICS) latest report from property professionals suggests that housing demand and property prices stand at an all time three year high across the UK. Simultaneously, the Council of Mortgage Lenders (CML) reported that Q1 lending to buy to let landlords had increased by £500 million to £3.7 billion against the same period last year, with the volume of property investments also helped by the loosening of credit to lenders through the Government and Bank of England Funding for Lending Scheme (FLS).

At the same time, Persimmon has seen its share value more than double across 2012–2013, with the house builder possibly assessing the prospect of promotion into the FTSE 100 Index on the back of the Government backed programme of making mortgages more widely available and investors seeking to inject their monies into reduced leverage, above average earnings and dividend yield land and property projects.

The only note of conservative caution being the fact that the behemoths of the UK Construction industry must maintain growth against a background of skills shortage, a low volume of Graduate level employees, high gearing, questionable quality of earnings and securing continued nationwide coverage, market penetration and control. At the same time, the Government must ensure that its scheme is processed under strict protocols less a damaging housing bubble be created unfettered.

Despite the continuing domestic UK and Euro zone economic concerns, London has continued to perform well and appears to remain an oasis of hope, sustainable development and refurbishment activity and increased tenant demand both in the City's Financial District and the West End.

Knight Frank, the leading property consultancy firm, recently released its top 20 league table vis-à-vis Global Office rents that placed London (West End) in second place behind Hong Kong with £1,022 per square metre of average annual rent which has risen 16% since last year as international companies seek the prestige of a St James or Mayfair office location; at the same time London (City) was placed seventh with £592 per square metre.

British Land remains one of the UK's biggest and most successful property firms with assets of £15 billion (second behind Land Securities in first place with

their pre-tax profit of £533 million) and has increased the value of its portfolio by 0.5% to £10.5 billion against underlying pretax profits of £274 million helped by the high profile £472 million sale of the opemaker lace development in March. With a circa £1 billion war chest available for further acquisitions, it has reported that there are plans for a significant investment of £500 million into London's West End and the South Eastern belt of the Home Counties.

British Land's success is reflected in a recent report by CB E that predicted a continued growth in prime rents and highlighted as evidence the 9% increase to £2.4 billion of new real estate investment into London retail sites in Q1 2013.

The Battersea Tower Station Development Company (B SDC) has reported that despite prices ranging from £350,000–£420,000 for the Circus West phase 1 development units, 94% have been sold off plan between January–May, with the 11 flats generating sales of £675 million. The B SDC hopes to sell the remaining 4 units across the summer as plans continue to be put in place for a further 3,400 properties and a circa two million square feet complex of hotels, offices and retail units.

The second part of this article is the exploration of whether the UK Surety market can support the recovery and needs of the UK Construction industry.

For those readers not accustomed to the vagaries of Surety, in simple terms it is an important mechanism to protect the contract conditions of the Employer (Beneficiary) whereby the Surety bond is a guarantee to pay the direct loss suffered as a result of a breach of contractual or legal obligations, or the Contractor (Applicant) becomes insolvent.

A Surety bond evidences the Contractor's ability to transfer the risks of default, non performance or insolvency to a Surety, providing protection for the Employer under the contract. Once the Surety bond facility is in place, this will enable the Contractor to confirm during the initial contractual negotiations and through the tender documents that the Contractor has the technical ability and the financial capability to complete the works on offer.

It is important to highlight the fact that Surety bonds are not contracts of insurance and because of the way in which they operate in the event that a bond is called and the Surety underwriter is required to pay, the Surety underwriter has a legal right of recourse back to the Contractor via a Counter Indemnity, and is entitled to seek reimbursement from the Contractor on whose behalf the bond has been issued. A Surety contract is a sacred and wonderful thing but one must remember that it is an iron clad contract that if either applicant or beneficiary attempts to slide out of it they will be bitten to death by a wild pack of lawyers!

By obtaining up to date information and by hosting regular underwriter – Contractor discussions, a preferred underwriter will be able to make decisions that are accurate, timely and well informed.

Each Contractor's needs are different, but there is a recurring theme of experience and expertise that underpins the current strategies being placed on behalf of several Oval Insurance Broking clients; we analyse the market and negotiate quality products available through identified underwriters; as there is not an abundance of individual underwriters to go to (less than a dozen Corporate and Lloyd's markets in total), this narrow panel means that the integrity of our proposition will be founded upon a strong balance between the scope of coverage, clarity of terms and conditions, premium and continuity of service.

We will seek to encourage and persuade the underwriters to "validate" the Contractor as a well established, well managed company that possess a robust business model, strong market character, credible profile, sufficient capital and technical competence; our assessment process then determines the security required from the Contractor to ensure their contractual certainty and integrity going forward.

The above means that the Contractor's participation in projects will be far more attractive to investors, banks and employers and act as a stimulus to their appointment as the ability of Employers to trade safely and with confidence becomes of paramount importance.

We have recently executed several all encompassing market reviews to create a "draw down" facility on behalf of Oval Insurance Broking clients, that evidence their ability to sustain the following Seven Stage Strategy.

This bond will be submitted by a Contractor with their tender document to demonstrate their ability to the Employer during the bid process that they are making a responsible proposal to win the project. The issuance of the bond will also evidence their ability to commence and complete the project in accordance with all of the obligations, as stipulated in the terms and conditions of the original tender documents if the contract is awarded to them.

The importance of this bond to the Employer (and Beneficiary) is that it prevents Contractors from submitting frivolous bids as they are obligated to pay the bond premium; by evidencing which Contractors are financially stable and have the necessary resources to take on a project, the Employer and their funders will be comfortable in awarding all, or part of the project to a particular Contractor.

2

This provides a guarantee up to the value of the bond that confirms the Employer will be

protected against the default by the Contractor of monies advanced to the Contractor. This is achieved by ensuring that the advanced sum will be returned if the agreement under which the advance was made cannot be fulfilled, and also ensures that monies are only expended on the contract.

As this type of bond will enable payment of cash to be made in advance of work being carried out, it provides significant cash flow benefits to the Contractor.

3

This bond provides a guarantee up to the value of the bond that confirms the Employer is protected against any losses and or damages sustained, should the Contractor fail to perform its contractual obligations because of insolvency, default or any other actions as defined in the contract or bond wording.

In the case of a dispute, the first action would be to the Contractor Sub-Contractor to remedy the issue, but if that fails and a “call” is made against the bond, the Surety underwriter will investigate the matter and if the claim is valid the value of the settlement payment will be established in accordance with the bond contract wording.

This bond provides a guarantee up to the value of the bond for payment of the Contractor's obligation under the contract for Sub-Contractors, labourers and suppliers of materials associated with the project.

This bond may be the only protection for those supplying labour or materials and as such will protect the underlying security of the project.

This bond provides a guarantee up to the value of the bond that the Contractor will fulfil its defects liability or maintenance obligations as stipulated in the terms and conditions of the contract.

This type of bond is normally issued to replace the need of placing on account a retention deposit, which is then released at the project's practical completion.

This collection of bonds are referred to as “ einstatement bonds” and are typically used for major construction contracts.

Given the intimate and intrusive nature of the potential detrimental effect on the environment, it is our opinion that the placement of these bonds is absolutely of the highest importance. The reason being is that it will ensure and prove that the landscape will be restored and or returned to a contractually agreed state following completion of the project.

In light of the local and environmental opposition to any project, these bonds should be seen as a pre-requisite to supporting the final planning permission.

- (a) (**3** A bond to guarantee to the Local Authority that roads, footpaths and lighting will be provided to a standard which they can adopt and complete.

- | | |
|-----|--|
| (b) | A bond to guarantee that drainage and sewer systems will be constructed to an agreed standard and maintained for an agreed period, before the Water Authority adopts it into the public sewer network. |
| (c) | A bond to guarantee to the Local Environment Agency that waste shipments will be organised to a standard that they can adopt. |

Harold Geneen of the International Telephone & Telegraph Company wrote in 1934: *“Business is many things. It is a fluid, ever changing, living thing, sometimes building to great peaks, sometimes falling to crumbled lumps. The soul of a business is a curious alchemy of needs, desires, greed and gratifications mixed together with selflessness, sacrifices and personal contributions far beyond material rewards.”*

Every gracious words for their time – however, this omits the most important element in the modern business era, the balance sheet.

The financial strength projected onto a successful applicant of a suite of Surety bonds and guarantees will allow solutions to be provided, even in the current difficult circumstances; the securitisation will increase banks’ capacity to lend and will lessen the considerable amounts of valuable resource and time in trying to recover lost momentum.

From our interpretation of trends within the UK Construction industry, it is clear that Employers are becoming increasingly vigilant when selecting and engaging with a panel of preferred Contractors and Sub-Contractors and are seeking to view with absolute transparency the ability of these contracting partners to fulfill their obligations.

In view of the above, the assessment and placement of a protective blanket of Surety products should be viewed by all construction related parties as a “must” have purchase and will be seen as a huge positive by their Employers as they operate under increasingly strict banking covenants.

Poorly performing or financially damaged Contractors represent the biggest threat to the success of any project and pose a huge risk to their Employer’s bottom line. Accordingly, as a Contractor pre-qualifies and submits their tender documents, they should have their financial strength evaluated through stringent checks, executed by the underwriter as evidence that they can meet the financial obligations for the whole term of their participation in the project. Accordingly, the Contractor’s ability to evidence its enhanced and stringent credit control procedures and financial strength to underpin a project’s valuation and viability will become a huge “plus”.

There are still those underwriters who when you introduce a new business opportunity to them will throw you the sort of filthy look they would usually reserve for a leper of whom they weren't particularly fond!

With the season of Ascot, Epsom, Goodwood and Newmarket upon us, I offer up an equine analogy for our Surety brethren; a race horse that can run the same mile a few seconds faster than its competitor, is worth twice as much that little extra proves to be the greatest value.

My belief is that as the economy strengthens and their balance sheets improve, the UK Construction industry will re-engage with the Surety market and wade into their capacity and support like thirsty camels arriving at an oasis after a long hard trek through the Sahara.

Money is king; both its creation and protection and as such Surety has developed from being a pure placement activity, to an important part of a developer's risk management programme. The appeal of Surety is no longer simply the assessment and placement of a standard policy product, but the information and transparency offered through access to the underwriters' refined and risk analytical disciplines, whereby clients instruct their brokers to create the corner stone of a complex financial and receivables management programme.

There is considerable doubt that a new player will enter the UK Surety market given the prohibitive start up costs required. In the past five years the established players have simply sought to consolidate their UK market position, namely, Euler Hermes, HCCI and SA. Other high profile underwriters, such as ACE, A I A and QBE in particular have recruited very well, and others such as AIG, Chubb, Travelers and Zurich have re-positioned themselves to win bigger ticket market share on the back of a conservative assessment criteria and their powerful financial security, at a time when the Surety market continues to (correctly) harden its pricing and securitisation subjectivities, to lessen losses and attract more reinsurance.

At Oval Insurance Broking, our clients want us to become an integral part of their risk management structure and as such we continue to work towards the creation of Surety strategies to complement their existing product portfolio of insurance, receivables management and financial securitisations.

The prevalence of internet driven on-line information systems enables clients to access high quality and up-to-date information in real time. However, we believe that UK clients, in an increasingly fierce environment, will continue to attach a high priority to the nature of the relationship that we seek to establish through our policy management and negotiation skills with today's modern CEOs FDs MDs who are more likely to align themselves to us because we understand their needs and will provide a pro-active and prompt service, rather than beating the drum of "biggest is best."

The UK Construction industry should avoid those brokers or Consultants that save them almost enough to pay their fee, or come down from the hill to shoot the wounded only after the battle is over.

We will engage our proven ability to understand the risk requirements and provide the right solutions through an attentive, knowledgeable, pro-active and professional service through our staff expertise, our market relationships and influence to identify and resolve unpalatable bond wordings and risks, our desire to act as a “risk manager” and not just a “price negotiator.” We will be sensitive and supportive as to where you want to take your business and can offer practical, sensible and time sensitive advice and action, so that the proposed bond facility is arranged with the most suitable Surety underwriters.

As per David Gardner’s pith observation: *“Success is getting what you want, happiness is wanting what you get.”*

The Euro one shows little signs of recovery and remains steadfastly stuck in its second recession in five years. An abrupt change in oil and other commodity prices would pose a serious risk to both economic growth and inflation across the UK. However, the Bank of England has recently predicted that the UK economy is expected to emerge from the mire and enjoy a period of genuine and sustained recovery and return to healthy growth across 2014–2016.

Non-payment and insolvency remains a very high risk when trading within the UK, externally across the European community and further afield; this risk will increase in the UK, not only in times of buoyancy and recession, but also in the recovery period.

The ability of the surviving UK Construction industry (with all its inherent financial problems) to operate and trade safely and with confidence, for a premium, will increase exponentially as developers seek to mitigate the huge threat to their own balance sheets of non-performance or failure; the corner stone of the most effective solution will be a Surety programme built upon credible financial information and a dynamic broker relationship offering cultural sensitivity and understanding.

In closing, I offer up a poignant toast that I trust you find sits well next to my commentary regarding the UK Construction industry, its woes, its recovery and the relationships required to sustain it:

*Do not walk in front of me, I may not follow.
Do not walk behind me, I may not lead.
Walk beside me, and just be my friend.
May there always be work for your hands to do.
May your purse always hold a coin or two.
May the road rise to meet you.
May the wind be always at your back.
May the sun shine warm upon your face.*

(Albert Camus)