UK construction: Consolidation ahead
UK construction: 15 players have annual revenues of more than £1bn

Recovery has arrived. UK construction has grown for eight consecutive quarters.¹ However, contractors, small and medium sized enterprises (SMEs) and civil engineers all report increasing cost pressures which are squeezing margins.

Against this backdrop, the top 15 have more than 60% of revenues and we expect this to increase.

Consolidation is inevitable:

► Buoyant market with diminished regulatory risk following highways commitments, Asset Management plan 6 and ongoing momentum in property and infrastructure.

► Significant scale advantages, from access to labour, in a market that is short of skills and value-adding capabilities.

► Strong business models that enable market leaders to deliver 5% returns whilst minimising risk, contrasting sharply with other participants that struggle to drive return on invested capital.

► Need to invest in plant, technology and innovative solutions which benefit larger players with strong balance sheets.

UK construction industry: top 100

Commentary:
The top 15 construction companies, all with over £1bn in annual revenue, generate more than 60% of the total revenues of the top 100.

¹http://www.theconstructionindex.co.uk/news/view/constructions-growth-run-notches-up-eighth-straight-quarter

Source: EY
By 2020, we expect significant consolidation of the leading players in the top 100 construction companies

We expect significant consolidation amongst the top 15; with each delivering:

► More than £5bn in revenue
► Approximately 5% PBT
► 5 service lines enabling complex services
► More than £50mn minimum project threshold

This process will mirror the process seen in comparable industries where the supply base has consolidated around leading participants (e.g., automotive tier 1, aerospace and professional services).

In addition, we expect a second tier of regional players will play a key role, providing specialist skills and/or local delivery capabilities.

Key drivers for consolidation:

► Globalisation – few, if any, construction companies with a truly global footprint
► Southeast Asia threat – buyers looking to invest in UK/EMEIA as an outlet for raw materials
► Major construction contracts increasing in size – e.g., Crossrail, HS2, nuclear
► ‘Corporatisation’ – economies of scale
What does it take to survive in today’s challenging business environment?

**Critical success factors**

- Ability to internationalise capabilities
- Bundling services to same customer base
- Disciplined operating model – zero tolerance culture, pricing excellence, contract transparency

- Strong customer focus and clear presentation of capabilities. Strong, recognised national brand
- Innovation alongside a lean and agile working model
- Recurring revenue streams and pipeline visibility

- Ambition to drive buy-and-build strategies with proven ability to deliver value from deals
- Focus on specialist services with transactional/support processes delivered via low-cost consistent models
- Predictability of cash flow and consistent delivery of market expectations
- Robust supply chain strategy and effective leverage of economies of scale
What are some of the early warning signs?

**Stakeholders**
- Absence of clear strategy (e.g., overstretching into non-core areas)
- Market concerns on credibility of corporate strategy and/or management
- Absence of proactive communication can undermine market confidence, particularly when a business is facing challenges
- Threat or emergence of shareholder activism
- Sudden or unexplained departure of CEO or CFO
- Suboptimal portfolio management

**Operations**
- Ineffective risk management over contract life cycle
- Lack of integration of acquisitions and new contracts
- Over-optimistic planning and forecasting impacting accuracy of forecast cash, capex and working capital requirements
- Loss-making or underperforming contracts
- Disputes and deductions due to operational underperformance
- Loss of key contracts/customers

**Markets**
- Overexposure to key customers without mitigating strategies
- Inflation relating to key inputs
- Overly aggressive pricing strategy locking in loss-making contracts
- New market entrants, particularly with local or specialist knowledge
- Absence of a complimentary mergers and acquisitions (M&A) strategy (divestment and acquisitions)
- Exposure to external cyclical factors (e.g., political changes, funding cycles and investment policies)

**Capital**
- Working capital/cash flow pressure caused by inadequate cash flow forecasting processes
- Risk of, or actual, covenant breach or missed interest payment
- Refinancing required within 24 months
- Profit warnings and earnings underperformance vs. peers
- Lack of forward visibility of cash or cash targets
5 key issues that businesses need to address

**Risk across the contract life cycle**
- Risk of contagion from a single contract failure to the wider business
- ‘Eyes open’ – clarity during tender/negotiations (e.g., risk/reward allocation between contracting parties)
- ‘Ability to deliver’ – strong/flexible operational capability to meet contract requirements
- ‘Visibility’ – clear management information (MI) is critical to allow timely monitoring at contract and consolidated level
- ‘Plan B’ – reactive ability to manage underperforming contracts and mitigate damaging public relations/costs
- Selective tendering – not simply tendering for every possible project but selecting those with favourable profit and cash terms

**Portfolio management**
- Use of M&A to appropriately diversify through acquisition and/or divest non-core business to strengthen the business
- Importance of managing acquired contract risk, through robust diligence and swift integration into existing MI reporting systems
- Challenge of establishing/integrating infrastructure necessary to support new/acquire contracts

**Cash is king**
- Over focus on top-line growth (and more generally EBITDA) at the expense of cash; need to view profit as secured once realised in cash
- Working capital stress through the supply chain is leading to businesses taking active steps to resist and/or pass down cash pressure to subcontractors
- Importance of evaluating and managing working capital profile across contract portfolios and tender pipeline
- Pressure on balance sheets to support bonding requirements, and liquidity levels to cope with lumpy cash flows (upfront costs/deferred receipts)
- Absence of a cash culture reflecting the historic lack of gearing

**Margin pressures**
- Historically low margins are being challenged further, irrespective of contract risk
- Maturing market limiting cost reduction opportunities and increasing sophistication of procurement processes squeezing margins
- Pricing pressure continues with top-line growth pressure and customers seeking ‘value’
- Limited focus on S&GA costs resulting in duplication of costs
- Weak and non-prioritised bidding process

**Front and back office**
- Minimal investment in IT and MI systems resulting in over reliance on manual processes
- Lack of accurate and up-to-date MI which prevents senior management understanding contract performance and issues
- High organisational complexity resulting in a fragmented culture, a lack of transparency and minimal management of innovation
- Absence of visibility at Group (and often divisional) level of active project performance and identification of emerging issues
- Weak processes to resolve issues leading to difficulty in collection of retentions and final account payments
What strategies are available?

To maximise shareholder value, management needs to make a clear assessment whether to focus on consolidation or being successfully acquired. Either way, there is a need for winning strategies that will enhance returns:

1. **Focus on successful consolidation:**
   - Set a clear vision for the business, supported by market trends and organisational capabilities.
   - Ensure there is flexibility in the cost base to be able to react rapidly to change.
   - Implement long-term financing and achievable debt covenants supported by robust cash forecasts.
   - Establish strong working capital performance.
   - Manage revenue risks – customer, product, market, competition and pricing.
   - Build a scalable business with centralised controls and consistent back-office processes that can be leveraged to support growth.
   - Be realistic about post-acquisition synergies.

2. **Focus on being successfully acquired:**
   - Actively engage in and align with equity, financial and other stakeholders; make sure they recognise the full value in your business.
   - Ensure operational risks (key supplier, input prices, disruptive innovation) are understood and managed; avoid trading surprises.
   - Build up cash balances and capital efficiency with robust management of any legacy liabilities.
   - Establish transparent market and trading data; ensure your position in the industry is clearly understood.
   - Build strong client base.
Selected EY credentials

Project Nexus
Lead integration and delivery of synergies

Project Pluto
Advice on synergy case and post-merger integration

Project Moon
Contract review

Project London
Synergy assurance

Project Hermes
Advice on cost reduction opportunities to support sale

Project Jupiter
Advice on synergy delivery from integration

Project Elephant
Diagnostic review of indirect cost base

Project Base
Review and enhancement of short term cash flow process

Project Chrome
Implementation of working capital and cash forecasting improvements to release £400m of cash in 12 weeks
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