Operating on a knife edge

By Mark Castle | 22 January 2018

The recent and tragic news about Carillion underscores how many principle contractors are operating on knife-edge margins, says Build UK's Mark Castle

In the 37 years that I have worked in the construction industry, profit margins (or the lack of them) have been a constant concern. The recent and tragic news about Carillion underscores how many principle contractors are operating on knife-edge margins, driving instability across the sector as a whole.

In 2017 it was reported that the top ten contractors averaged a loss of 0.8%, whilst the rest averaged profit margins of circa 2%. This is at a time when the construction industry has been rightly expected – and indeed required – to up its game on a whole host of measures from skills development and sustainability through to innovation and productivity.

If companies throughout the industry supply chain are to invest in apprenticeships, drive innovation, support the digital revolution and rise to the challenges of being sustainable and responsible businesses, everyone must be able to earn a sensible level of profit. We cannot invest in the future while earning negative or tiny margins.

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There is an inequitable balance throughout the industry, from clients all the way down to the specialist trades at site level. If we don't address profit margins, the industry will continue to under deliver on its promises and fail to realise its true potential.

Clients – whether developers or end users – will always argue that a 15-20% rate of return is an appropriate level of profit considering the development risk they take on. The subcontracted supply chain average an operating profit of 5%. The main contractors take home a slim 2% and I will happily admit that they don't always help themselves – we all live in a competitive market place – but attitudes need to change.

Too often, companies are simply asking for trouble; committing to build projects in undeliverable timescales, taking on contractual risks that are geared heavily in the client's favour and offering tender prices that are carved to the bone.

Most main contractors then look to pass on those contractual risks through their supply chain. As has been clear in recent days, subcontractors can easily be left high and dry when contractors face financial difficulty, putting thousands of livelihoods at risk and threatening to derail crucial infrastructure projects.

The industry has had standard JCT/NEC contracts in place for years – and yet some players in the industry continue to persist in rewriting contracts to push increased and often unfair risk onto a third party with clients reluctant to pay an appropriate premium for that risk transfer.

I firmly believe – particularly in light of recent events – that across the sector we all have a collective responsibility to review the rules of the engagement. The Farmer Report made it clear that the current model is not sustainable and will limit our sector's capacity to grow and to deliver the UK's much needed pipeline of property and infrastructure.

Clients set the direction of travel, and so have a key role here. We recognise that there are some great clients out there leading the way in collaborative procurement, who truly understand shared risk and reward and who genuinely want all parties to make a profit.

However, if the construction industry is to meet the ambitions set out by Mark Farmer, then more clients have to come to the table with a different approach. Contractors can make a difference, but industry modernisation cannot be one sided.

We are now entering a business cycle where the market appears to be showing signs of tightening, pipelines are shrinking and development appraisals are coming under pressure as asset and sales values peak – and yet we have residual tender cost inflation still coming through. It is already clear that this market is unlikely to take many prisoners. The result is that schemes across the UK are once again becoming marginal.

Such challenges inevitably bring about changes in behaviour and how we go about business. Those of us with enough grey hair (a category which definitely includes me) see the worm turning as all the hard-won good work around collaborative procurement starts to be undone and we are already beginning to see early indications of a resurgence of single-stage lump-sum bidding.

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It baffles me – we never seem to learn! The UK's construction industry could be world-beating; it certainly has the potential to become an innovative, productive, collaborative and service focussed machine. Sadly, we're held back by claim-conscious behaviours, stoked by forms of procurement with their origin in a history steeped in project and relationship conflict.

Personally, I support what many industry leaders have suggested: that both main and specialist contractors must aspire and look to achieve operating margins of 5%.

Clients will understandably argue that their development appraisals are already stretched and PQS cost plans are tight. Specialist contractors will say that their risk profiles are over-extended already.

The challenge then becomes: how can we generate the additional margins? How do we add that additional value? There is no magic silver bullet here – but we all have a part to play.

There are a number of elements that must come together to drive real change:

- An end to bespoke contracts driven by clients, designed to pass unreasonable risk down the supply chain
- Sensible cost plans from PQS's, which challenge without being unfair or manifestly incorrect
- Designs that work, and are modelled, integrated and properly co-ordinated between all parties

To have any chance of achieving those objectives, we need honest conversations between clients and contractors about agreeing a reasonable level of return for all parties. You reap what you sow – the contractor who bids work at an unsustainable margin and the client that accepts their offer deserve each other!

In order to deliver the UK's ambitious infrastructure, housing and commercial needs, we all recognise that the construction industry must transform itself. It is clearer than ever that we can't go on as before.

Those who don't learn the lessons of history are doomed to repeat it – and the lessons of the last few weeks are ones that we can't afford to ignore.

It isn't hard to see that the challenges facing our industry are only going to become more acute. To tackle them we need to work together. It will be telling to see how many of the enlightened grasp the nettle and lead by example – and how many sit back and leave it to the next generation.

Postscript

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