City-REDI
Policy Briefing Series

March
2018

Part B
Carillion's Collapse: Consequences

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Carillion, the second-largest construction firm in the UK, were proud of their commitment to support regional growth and small-scale suppliers. As part of this commitment they directed 60% of project expenditure to local economies. Following the collapse of the firm, this positive multiplier effect became a significant, negative multiplier effect, particularly damaging to small-scale suppliers in the construction industry. The aim of this policy brief is to examine the consequences of Carillion's demise, many of which are only now surfacing. One of the fundamental lessons that we can learn from Carillion's collapse is about these 'contagion' effects. As we saw in the 2008 financial crisis, the businesses that underpin the economic health of the country are connected and strongly co-dependent. When a large flagship firm falls it brings down others. This does not mean we need *more* state intervention. But it does mean we need *more intelligent* state intervention. One of the fundamental lessons that the Government can learn from the Carillion episode is that it has a significant responsibility as a key customer, using public sector funds for public sector projects, to monitor the health of firms and assess the risks prior to issuing PPI and other contracts.

Introduction

The collapse of Carillion, the second-largest construction firm in the UK, has had a significant, negative knock-on effect, particularly on small-scale suppliers in the industry. In total, Carillion was comprised of 326 subsidiaries, of which 199 were in the UK. The demise of the construction giant has also prompted a serious look at how the UK Government contracts private sector firms to run public sector services, from prisons and hospitals to school dinners. Following some of the causes of Carillion's collapse illustrated in Part A, in this briefing we discuss the wider consequences amongst the UK economy.

Overview

Overview of Carillion

With 43,000 employees globally and 19,000 in the UK (about 2,000 in the West Midlands) Carillion was second only to Balfour Beatty in terms of turnover. Carillion's operating activities stemmed across three main segments: support services; project funding; and construction services. Although only 6% of revenues were acquired with Public Private Partnership Projects in 2016, as the majority of revues were acquired in the UK, the firm was inevitably dependent on the success of projects within the UK. More information concerning Carillion's UK projects can be found in Part A.

Consequence

1. Jobs & Pensions

The first and most obvious impact of the collapse of Carillion has been the direct unemployment of many of its workers. Carillion were headquartered in Wolverhampton (West Midlands) and employed Approximately 2,000 people within the region. In total, approximately 400 people were employed at the HQ office. Following the announcement of Carillion's meltdown, the Government announced that it would protect the jobs of employees working on public related projects, such as the £350m contract for Midland Metropolitan Hospital and the £335m contract for the Royal Liverpool Hospital. However, as the majority of public related projects jobs that are being saved simply involve being transferred to different companies, it is likely that back office jobs administrative jobs will no longer be required, thus the majority of the 400 people employed at the HQ will most likely lose their jobs. The Official Receiver, which is part of the Government's Insolvency Service, estimates that the total number of Carillion jobs lost is 1,582, but this number is likely to rise. At this stage redundancies have mainly been in a mix of back-office functions or engineering support roles that are no longer required by new suppliers.

However, while the number of redundancies is increasing so is the total number of jobs secured. To-date, approximately 8,592 jobs have been protected. The Official Receiver asserts that these protected jobs sit within private sector contracts, not just public sector projects. Crucially, approximately 10,000 Carillion workers are awaiting to hear about the fate of their jobs and face an uncertain future. Furthermore, MPs have raised a new issue concerning the employees who have been redundant. Because of the financial complexities that need to be unravelled former Carillion staff are being left in the dark and could wait six weeks for redundancy and statutory notice pay. The loss of pensions for many of these employees, given the £587m deficit in the pensions pot, has raised serious questions about the need to remove employee pensions from management control. Carillion grew fast by taking over companies, including Alfred McAlpine, Mowlem and George Wimpey. Each deal brought with it a pension scheme, and the combined schemes, which have nearly 30,000 members, are estimated to be at least £990m in deficit. The Government's pensions lifeboat, the Pension Protection Fund (PPF), is expected to assume a liability of up to £900m, its largest ever. It has enough money to do that, but scheme members will face pay-out cuts of about 15%.

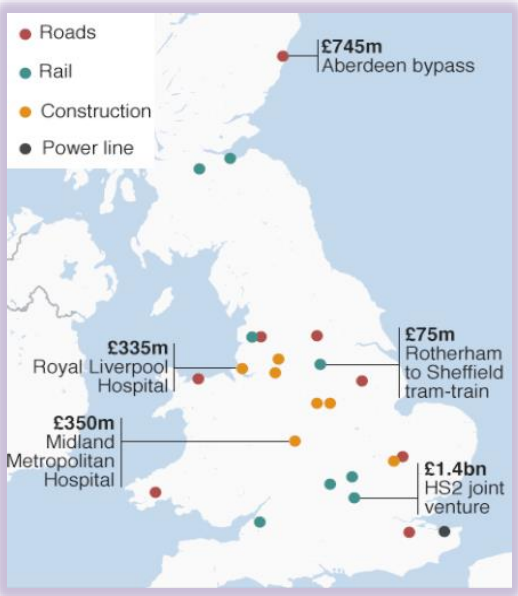
2. Supply Chain Uncertainty

The second major effect is on the firm's large and complex supply chain, with the smallest enterprises bearing the brunt. The construction industry is made up of a relatively small number of large firms (Balfour Beatty, Kier Group, Interserve, Morgan Sindall, Amey) and a very large number of contractors. Before the collapse of this flagship firm many suppliers were already feeling the squeeze as Carillion tried to shore up its own finances by delaying payments to suppliers.

Consequences

For instance, some suppliers have reported that they had to wait over 120 days to receive payments for goods/services creating serious cash-flow problems compounded by unsympathetic banks. An estimated 7,000 first-tier suppliers and contractors will be impacted by the collapse of Carillion. Mark Farmer, an industry expert has stated that the demise of Carillion could be the first of many catastrophes amongst the giant construction companies and the 'true' scale and costs are yet to emerge. Although Carillion's headquarters were in Wolverhampton, it important to note that its employees and its network of contractors, were distributed nationally, matching the location of its major projects. Its multiplier effects were less regionally concentrated than, say, JLR. But, given the firm spent approximately 60% of its expenditure on local businesses, the regions where its largest projects were located are facing the largest negative impacts, see Figure 1.

Figure 1: Mapping Carillion's Largest UK Projects



Source: BBC (2018)

The West Midlands does, however, home two of Carillion's larger projects (Midlands Metropolitan Hospital and Paradise Circus), so the region may be more vulnerable than others. The average construction firm in the UK is thought to possess a multiplier effect of £1:£2.84. This is a positive effect when a firms is solvent and a negative effect when it collapses. A point that has been overlooked in discussions about Carillion.

Beyond the 20,000 people directly employed by Carillion in the UK, applying the multiplier ratio outlined above, up to 60,000 UK jobs are at risk. Furthermore, Carillion's multiplier effect is likely to be higher than the industry average, because 60% of their external expenditure was directed at local economies. This is positive for 'inclusive growth', but comes with the same magnitude in the form of negative effects when the firm fails. Small-scale suppliers at the bottom of the supply chain are unlikely to be compensated, meaning that redundancies will fall mainly on lower-skilled workers, adding to the burden on social services. Carillion's liquidation will undoubtedly send large ripples through the entire supply chain, particularly because up to 30,000 small businesses are thought to be owed money by Carillion, according to trade group Build UK, some of which are also likely to collapse. Experts have suggested that Carillion may not be the only construction firm to die, as shrinking profit margins and financial fragility as two symptoms of a broken industry which either need to 'modernise' or 'die'.

3. Clients & Big Firms

The third group to be affected by Carillion's collapse are the clients and large firms. This includes a wide range of Government contracts including those to build part of the high-speed rail line between London, Birmingham, Leeds and Manchester; manage 900 buildings nationwide; and maintain 50,000 homes for the Ministry of Defence. One of the largest casualty amongst the listed companies has been Van Elle Holdings, who undertook several contracts for Carillion during December 2017. The closure of Carillion has left the firm with outstanding debt and work-in-progress worth approximately £1.6m. Speedy Hire (SDY), generated revenues of £12m in 2017, and is another big firm owed £2m by Carillion. Other big firms impacted include Carillion's rivals Galliford Try (GFRD) and Balfour Beatty (BBY), who must cover approximately £60m-£80m that Carillion would have contributed on the £550m Aberdeen Bypass. Financial provider Barclays also must take a £127m hit from Carillion's collapse. Surprisingly, Serco, who are a public services provider, have been found to benefit from Carillion's closure. The firm agreed to purchase NHS facility contracts from Carillion last year for £48m , however it will now pay almost 40% less than initial estimated costs. Furthermore, Interserve, a company with 25,000 staff in the UK supplying the public sector in health, education and defence, is now under scrutiny by the government because of concerns about the outsourcing industry. Capita, is another firm the government must watch 'more closely' as its shares have collapsed from £13 to 175p in less than three years.

Policy Recommendations

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1. Reduce the contagion effect on small firms by preventing late-payments to contractors.

Many small suppliers operating upstream in the construction industry have had to make employees redundant and cope with even greater risk and vulnerability after being owed money by Carillion. Government should take steps to stop late payment by large firms because of the 'contagion' effect this creates across the wider economy. Carillion commonly paid subcontractors and suppliers after the 120 day limit. Late payment has been identified as one of the biggest challenges facing small businesses in the UK, with an estimated 50,000 failing each year because late payments lead to serious cash flow problems.

2. Monitor the business health of firms that receive significant amounts of government contracts and underpin public service delivery.

The government, as the custodian of public funds, must monitor firms with PPIs and evaluate their 'business health' more robustly prior to issuing contracts.

3. Consider direct government intervention in the case of failing firms that are funded through PPIs.

Recently it was reported that EY knew that Carillion were in financial trouble and estimated that selling the profitable parts and placing the rest into liquidation could have generated £364m, including £218m for the company's pension schemes. The Government was aware of this divestment strategy, but did not push Carillion down this path in order to maintain the operation of public services.

4. Government needs to be more joined-up to monitor overall risk across the portfolio of ministries awarding contracts to one or a small number of large firms.

A large range of public sector contracts were heavily reliant on Carillion. This level of risk should be avoided and this would limit the multiplier effects and lower the chances that public sector service delivery is compromised.

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