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Still in bloom?

Challenges facing temporary labour

Restructuring

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Foreword

Welcome to our first report on the temporary labour sector, primarily for lenders operating in the sector.

The recruitment sector (temporary and permanent labour) is often considered a barometer for the wider economy. The recruitment sector continued to grow in 2017 driven by a resilient labour market. M&A activity is buoyant for recruitment agencies supplying into sectors such as technology (including cyber security) and life sciences where there is high demand for people.

However, whilst our 2017 Recruitment Index found that the majority of recruitment agencies reported an increase in net fee income, 24% reported a decline, the highest level recorded since the index began.[1]

Our report is focused on the temporary labour sector where agencies are in particular facing a period of change and uncertainty. The Deloitte 2017 Recruitment Index showed that the largest firms, which are more likely to be temporary labour agencies, recorded the lowest levels of net growth.

The market is characterised by a large number of firms, often providing labour into low skill/blue-collar jobs and operating with thin margins.

Businesses have been adversely impacted by a raft of legislative and administrative changes in recent years, an increased level of scrutiny from HMRC and a focus on workers' pay and employment status.

These legislative changes have led to increases in costs and reductions in profit margins for some agencies whilst others are subject to ongoing HMRC investigations and potential sizeable claims (which can back date a number of years) and could have an adverse impact on cash flows.

These factors are leading us to see increased stress in a sector where businesses are typically highly leveraged and the ability to raise additional finance in times of stress is limited. Alongside this, external factors such as uncertainty in the business environment, potential further tax changes, the possible impact of Brexit on the labour market and technological changes provide additional challenges and opportunities.

We hope the report provides an insight into these issues to enhance your understanding of the challenges faced and those which lie ahead.

Lenders in particular should be aware of the headwinds faced by their customers in order to be able to act quickly in the event of signs of stress. Throughout this report we have provided actions which lenders should take when their customers face the challenges we have outlined.

Clare Boardman
Partner, Financial Advisory –
Restructuring Services

Katie Folwell-Davies
Partner, Financial Advisory –
Human Capital Services Lead

Introduction

Britain's temporary labour industry is worth £35 billion and employs an estimated 1.6 million workers (nearly 6% of all employees), forming a key component of the labour market.[2,3] When you consider the temporary labour sector far exceeds the size of the permanent recruitment sector, which is worth an estimated £3.2 billion, the importance of the sector becomes clear.

Temporary labour agencies face a seemingly endless wave of new regulations and a struggle to maintain profitability.

Yet for much of the time the temporary workforce is largely invisible, coming to public attention only as part of a supposed 'bad news' story: the reported treatment of workers in distribution centres, the use of advantageous tax schemes, the underpayment of the National Minimum Wage ("NMW"), or solvency problems at a temporary labour agency or an end customer that threatens to leave hundreds of temporary workers without employment.

We publish at a time of great change in the industry. Temporary labour agencies face a seemingly endless wave of new regulations and a struggle to maintain profitability. Margins are under constant pressure but there remain opportunities to make strong profits, particularly for those supplying the white-collar or niche sectors where interest from private equity is focussed.

There is considerable uncertainty for those who do business in the sector, whether as owners, directors or commercial counterparties and in turn uncertainty for lenders who have provided funding to these businesses.

Overview of the issues to be addressed

This report highlights key characteristics of the sector and the drivers impacting current and future performance. We take an in-depth look at the challenges faced by the industry, from increased regulation to the advance of digital technology.

Regulation and taxation

Concerns about the insecurity of employment in the so-called "gig" economy (a term embracing casual workers, freelancers and others typically on short term contracts) prompted the Government to commission a report by Matthew Taylor, chief executive of the Royal Society of Arts. The report recommends key changes in the rules governing temporary workers, the self-employed and those working in the gig economy.

Additionally, the temporary labour sector still faces many specific tax challenges, for example the use of personal service companies ("PSCs") in the public sector was addressed by the off payroll in the public sector legislation in April 2017. HMRC's May 2018 consultation document 'off payroll working in the private sector' broadens the reach of this legislation across the whole industry.[4] Extending the rules to the private sector seems the favourite of three options proposed by HMRC, with implementation likely by April 2020. HMRC also pays close attention to adherence to the payment of the National Minimum Wage.

Profitability and creditworthiness

Barriers to entry are low, competition is high and, in the field of blue-collar temporary recruitment, the largest single area the sector supplies, profit margins are thin.

Furthermore, the lack of management experience and the high proportion of the sector which is owner-managed can lead agencies to take on new contracts that generate revenue growth but prove to be unprofitable. Such a lack of financial grip can too easily lead to trading underperformance.

Macroeconomic outlook and Brexit

Since 2009, the UK economy has expanded, unemployment has fallen and interest rates have remained at historically low levels. The prospect of a return to more traditional interest rate levels threatens to capsize many so-called zombie businesses kept afloat only by very low borrowing costs. Some may be temporary labour businesses, some may be their customers.

Meanwhile, Brexit poses a double challenge. The uncertainty surrounding the UK's departure from the European Union could depress economic activity and demand for temporary workers. It could also reduce the number of European Union workers coming to Britain looking for temporary work.

New challenges and opportunities

New market disruptors – automation, technological change and the shift towards increased flexible working – provide new challenges and opportunities and will impact how agencies will need to operate in the long run.

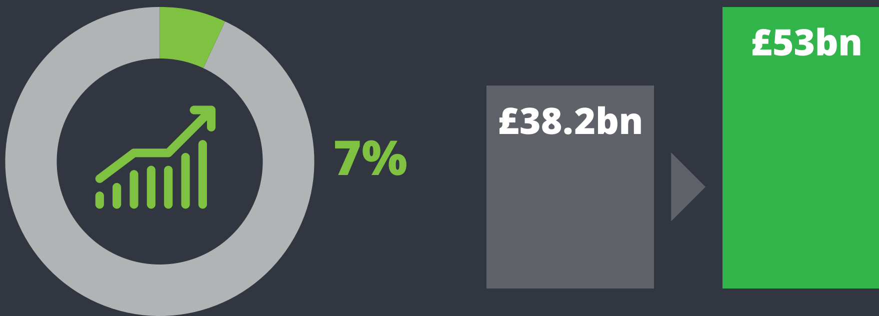
Together these four issues are driving a period of uncertainty and change for businesses operating in the sector. We highlight the potential pitfalls and warning signs a lender should look for when considering the performance and viability of a customer.

Industry overview

Market context

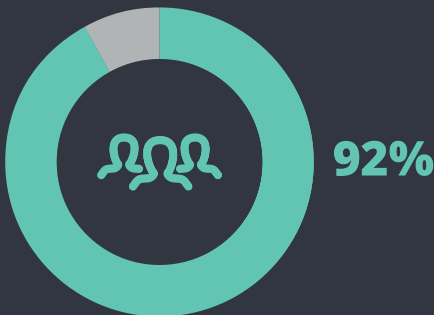
A mosaic of very different businesses

Temporary labour agencies offer the end customer labour on a flexible and often short notice basis to meet demand. As businesses look to achieve a more flexible operating model, including a more agile workforce, the number of people in temporary roles is expected to increase:

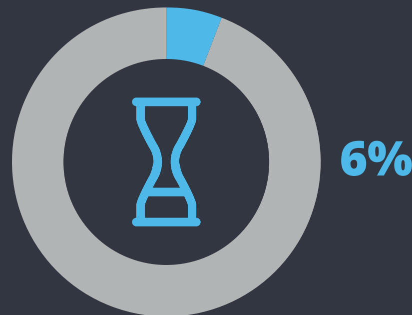


The **level of growth of the recruitment sector** (temporary and permanent agencies) in 2017 compared with 2016.[2]

The **size of the recruitment sector** (temporary and permanent agencies) in 2017 and forecast size in 2022.[2]



The **turnover of temporary labour agencies as a percentage of total recruitment sector turnover** in 2017.[2]



The **percentage of the workforce who are in temporary roles**.[5]

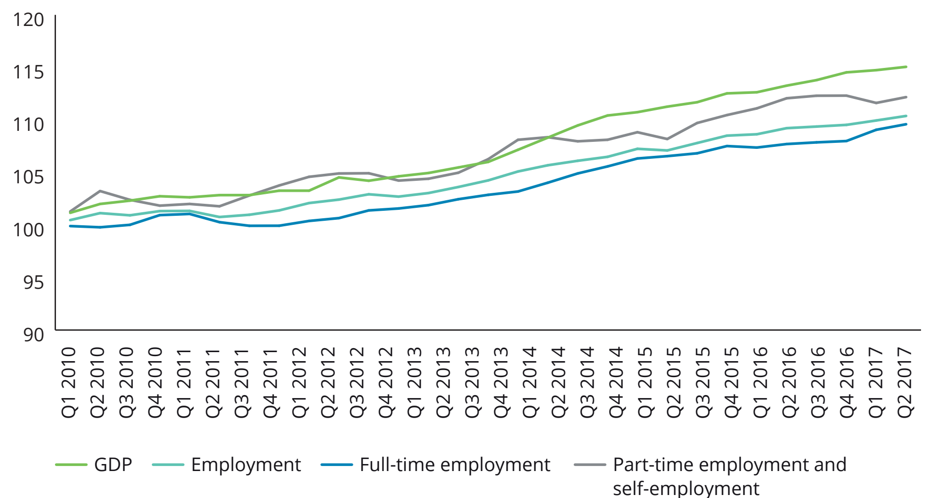
As businesses look to achieve a more flexible operating model, including a more agile workforce, the number of people in temporary roles is expected to increase.

Recent growth in employment has been driven by temporary workers.

Economic context

UK unemployment in 2017 was at the lowest level since the 1970s. Growth in employment has been driven by temporary workers:

Index of UK GDP and employment (2010 = 100)



Source: Office for National Statistics and Deloitte analysis

Sectors supplied

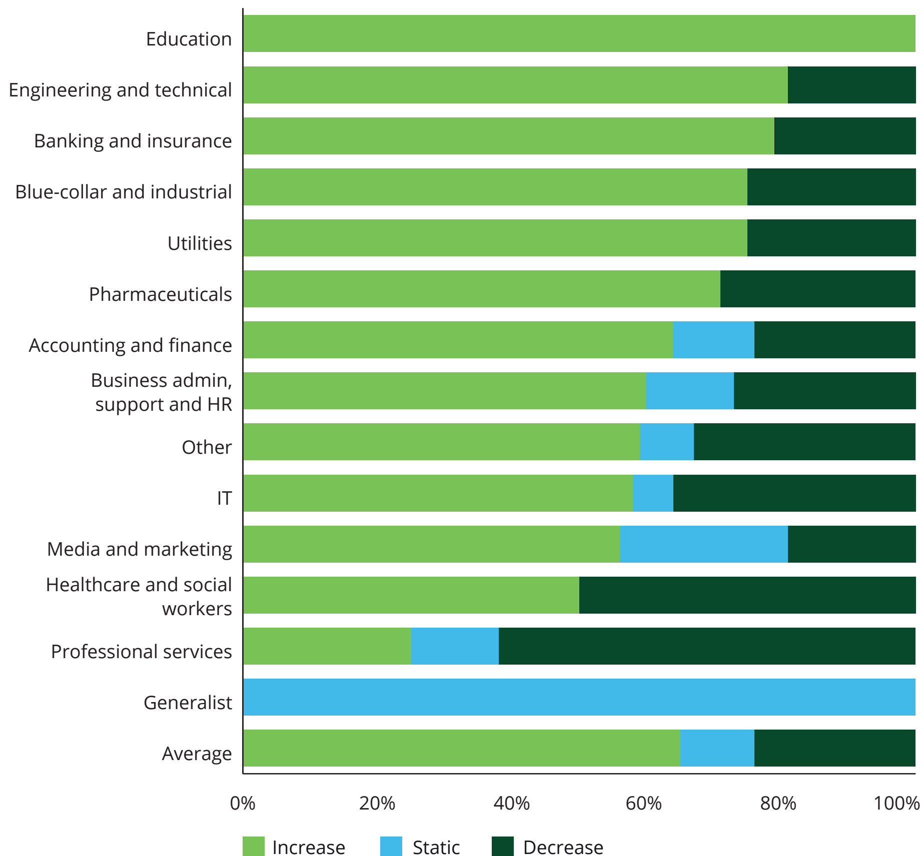
Temporary labour supplies workers across all industries.

Whilst the majority of temporary workers are employed in **blue-collar (21%)**, **engineering (15%)**, and **secretarial/clerical (14%)** roles, a number of other sectors and industries, including teaching and IT, rely on temporary labour to fill vacancies.[2]

Net fee income by sector

Our 2017 Recruitment Index highlighted a split in the growth of net fee income between sectors. Growth was seen in most areas including education (where the further education sector is seeing a high level of merger activity) with a net decline seen in the healthcare and professional services sectors.

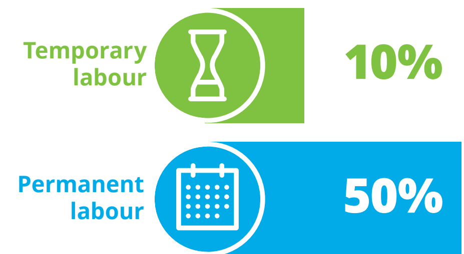
Annual NFI movement by sector, percentage of respondents



Source: The Deloitte 2017 Recruitment Index in association with APSCo

Operating margins

The operating margins of temporary labour agencies tend to be lower than those of permanent agencies.[6]

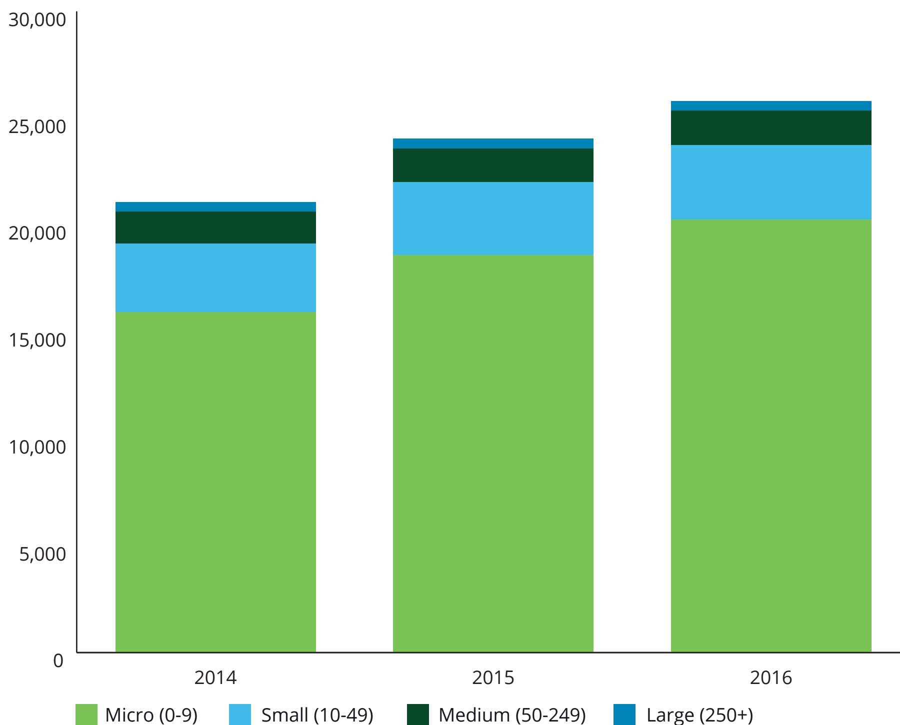


Size of recruitment agencies

The recruitment industry is fragmented. The growth in the number of recruitment agencies has been led by small/micro firms which employ less than 50 employees (more than 23,000 firms) and tend to supply local/niche customers. Only 40% of these provide temporary labour.

Only a relatively small number (460) of firms employ more than 250 people. Nearly 80% of these firms are temporary labour agencies.

Composition of UK recruitment market by firm size (number of employees)



Source: Office for National Statistics and Deloitte analysis

The growth in the number of recruitment agencies has been led by small/micro firms which employ less than 50 employees (more than 23,000 firms) and tend to supply local/niche clients.

Industry overview

Typical sector dynamics and challenges

Lenders should be aware of the following dynamics faced by temporary labour agencies:

1. A need for invoice finance
Temporary labour agencies undertake work that can be low margin and with long payment terms. Invoice financing can fill the gap between the typical requirement to pay temporary workers weekly and the monthly billing of customers with 60-120 day payment terms.

Invoice finance
For temporary labour businesses, lenders will commonly advance up to 90% of the approved debtor's ledger, typically higher than for other sectors.

Such lending is seen as a reasonably straightforward transaction. Workers' hours are recorded on timesheets and invoices are raised regularly. There is a detailed audit trail (assuming there is access to a timesheet data system).

2. Overestimating company size and solidity
Due to the nature of the business, owners can overestimate the size and solidity of the company they are running. A temporary labour agency can have revenue of, for example, £100 million, which can suggest to the owners a substantial enterprise.

It may respond by expanding the management team and incurring other overheads. The challenge is that the vast majority of that £100 million is being paid to the people on the agency's books. In reality, the agency is making payments of wages, acting as a payroll service and charging the customer commission for doing so. The underlying value added is the level of commission charged, which may be closer to £10 million.

In other words, the temporary labour agency now has management and other overheads which are top heavy relative to the real size of the business.

3. The loss of key personnel

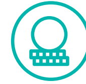
Temporary labour businesses are vulnerable to the loss of key personnel. The quality of a temporary labour agency's own permanent employees is central to its success. Recruitment agencies are people businesses and the quality of fee earners is critical given their dual role in terms of representing the agency both to candidates and customers.

Unsurprisingly, agencies have a strong focus on investing in staff recruitment and development. Target setting and performance monitoring are standard practice in an industry driven by key performance indicators.

4. The transience of temporary workers

A further potential problem area relates to the temporary labour agency's other key asset – the temporary workers themselves – who are capable of walking away and joining another agency.

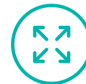
However, there is a difference in the risk between white-collar and blue-collar workers. The former are skilled individuals who can be on the same agency's book for ten years and are more likely to have an affinity to their employer due to the agency's niche focus and experience. Blue-collar workers have markedly lower levels of agency loyalty, given their skills are more general and easily transferred to another business. Significant resource and therefore cost is continually required to focus on ensuring labour is recruited in.



5. National Minimum Wage ("NMW")

The NMW recently increased from 1 April 2018 (the NMW increased to £5.90 per hour for those aged 18 to 20 and £7.38 for ages 21 to 24 and the National Living Wage (the national minimum wage for those aged 25 and over) increased to £7.83).[7]

Temporary labour agencies often provide low skilled, low paid workers. Any increase in the NMW will have a direct impact on wages paid. The key is whether these costs can be passed onto the end customer under the terms of contracts. We comment further in the Regulation and Taxation section.



6. Over reliance on a few big customers

A major source of business risk is the over reliance on a few big clients. Agencies working for a large company in retail or banking are likely to come under heavy payment pressure, getting paid at the customer's convenience, although invoice financing can mitigate this problem. Such customers may hold the power in the relationship and the ability to put pressure on margins.

When a temporary labour agency serves a single big customer, this arrangement can work well for a while and the agency can enjoy rapid growth. But what if that customer closes, changes its terms, stops growing, decides to bring its costs under control or faces its own cash issues? There is therefore always the risk of losing the contract the agency is over reliant on.

We will now focus on the four key drivers impacting current and future performance that we outlined in the Introduction.

Regulation and taxation

The Taylor review – temporary work and the "gig" economy

Businesses in the temporary labour sector have been adversely impacted by a raft of legislative and administrative changes in recent years, leading to increased regulation, compliance, costs and subsequently impacting on profit margins.

Matthew Taylor was asked by the Government to look at modern practices for the engagement of workers, focusing on rights and protections.[8] A focus of the review was individuals providing their labour in the 'gig' economy, being paid on a per job basis, such as couriers and taxi drivers.

The key recommendations of the report (released in July 2017) included:

Employment status – There should be a clearer and consistent definition of 'worker', to be renamed 'dependent contractor' and greater clarity on the boundary between employment and self-employment, to make the position clearer for both engagers and workers. Individuals working in the 'gig economy' should be treated as 'workers', with the benefits and protections that worker status brings.

Pay practices – There should be more flexibility in the NMW rules to accommodate different types of pay practice. To reduce the one-sided nature of zero hours contracts, it was suggested that NMW rates should only be available for specified contractual hours, with premiums payable for additional hours.

Tax and NIC – Workers should be treated as employees for tax purposes, with tax/NIC withholding being operated and employer's NIC being payable by the engager. The differential in NIC between the employed and self-employed should be reduced, moving towards making the taxation of labour more consistent.

Rights and protections – There should be greater transparency of contractual terms with employers and agencies being required to provide written statements, both for employees and workers. It suggested allowing agency workers and those on zero hours contracts the ability to request their working relationship to be formalised based on the way they operate in practice. The operation of the Swedish derogation, which is popular with some agencies, should be reviewed and possibly abolished and umbrella companies should be subject to greater regulation.

Gig economy: The term "gig economy" reflects an increase in the prevalence of short term contracts including casual workers, freelancers and others typically on short term contracts rather than in permanent work.

Workers are paid on a per job basis rather than receiving a traditional regular wage.

Up to five million people are now thought to work in the gig economy.[9] The growth in the gig economy suggests flexible working is more important and will continue to be in the future.

Swedish derogation: Where a recruitment agency offers an agency worker a permanent contract of employment and thus does not have to comply with certain elements of the Agency Worker Regulations, particularly regarding pay.

Umbrella companies: Typically a business sitting between a recruitment agency and a worker which employs the worker and is responsible for PAYE/NIC and other employee compliance considerations. The term 'umbrella company' can refer to a wide variety of business models, care should be taken to examine each individually.

Government response

In February 2018, the Government published its response to the Taylor review.[10] Its intention is to preserve flexibility within the labour market, which helps businesses create jobs, while affording workers appropriate protections on their pay and rights.

Alongside this, four consultations commenced to consider the Taylor review's main recommendations. The two key themes across the consultations are employment rights and employment status for tax purposes. It is encouraging to see the Government seeking to consult comprehensively but it means that agencies are likely to be subject to further increased regulation.

All the issues raised by the report are highly relevant to the temporary agency sector. Any new regulations, which may arise following the recommendations, could add further pressure on agencies with new compliance requirements and additional costs to meet these.

Regulation and taxation

Regulation changes and HMRC focus – tax issues in the temporary labour sector

Notwithstanding the Taylor review, there are already a number of live tax issues which are specific to temporary labour agencies. Lenders and those with an interest in the sector should be aware of four key issues in particular which may impact on trading performance and cash flows.

VAT on full costs or margin?

The Adecco VAT case, which has been examining whether VAT is charged on the total costs of providing a temp (i.e. the wage costs and the temporary labour agency margin) or just on the margin, continues to progress through the courts. The case is shortly due to be heard in the Court of Appeal and agencies will need to react to the judgement accordingly.

The impact on cash flow profiles should be considered particularly where there is invoice discount funding. If it is decided that VAT should be charged on margin only (rather than costs and margin), the value of invoices which lenders will advance against will be lower.

Employment taxes and travel and subsistence

Employment taxes have been similarly complex, driven by potential savings derived from the use of different types of structure. It would be fair to say some businesses in the temporary labour sector have been more focused on tax planning than recruitment and staffing. HMRC has reacted to these developments and introduced a range of new employment tax legislation and anti-avoidance initiatives in recent years.

One of the most popular types of tax planning in recent years was "travel and subsistence planning", whereby an element of once taxable hourly pay was purported to be a reimbursement of allowable expenses, thus making it tax free. The implementation of such arrangements varied wildly and HMRC legislated against the practice with effect from April 2016. Tax relief is now only available for work travel required by customers but not for travel to customers. It remains unclear whether all agencies have correctly implemented these changes.

Many businesses have faced increased costs and reduced profit margins whilst others with more aggressively implemented arrangements face ongoing investigations and (potentially sizeable) claims including fines from HMRC for liabilities going back up to six years.

Personal service companies ("PSCs")

A key remaining tax efficiency is the use of PSCs. The attraction in such structures is shown by the potential tax savings as highlighted in the graphic opposite. This shows the total tax payable where PSCs are used (where IR35 does not apply) is lower than for the other forms of engaging.

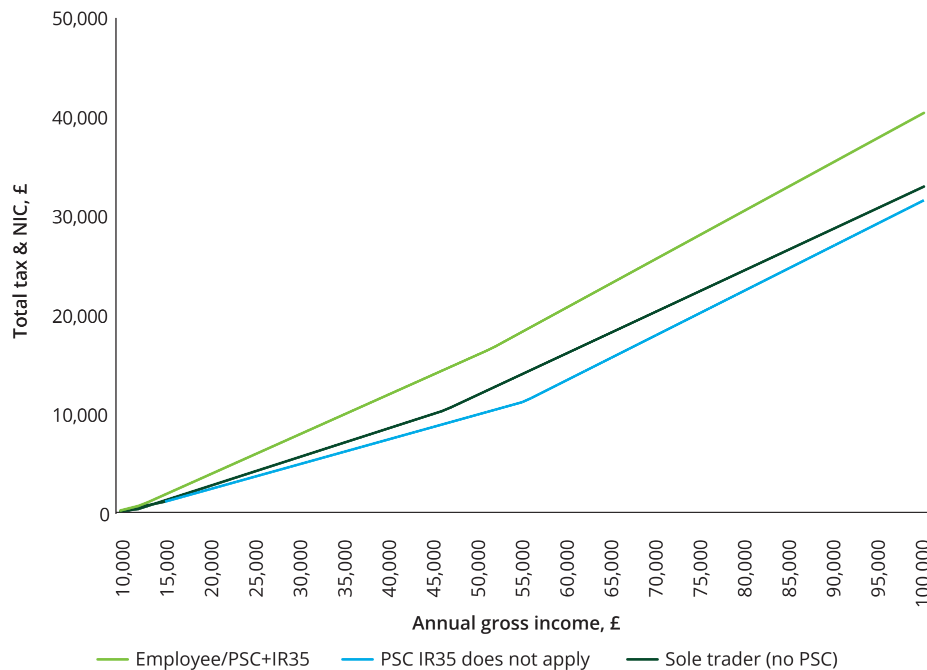
However, these tax savings are only available where the PSC escapes what are known as the "IR35" rules – i.e. the worker is genuinely acting as self-employed for the end customer, as opposed to as an employee.

HMRC has estimated one third of all PSCs should be operating IR35, but that only 10% of those actually do so. To tackle this, IR35 was amended from April 2017, so that where a temporary labour agency engages a worker through a PSC and supplies the worker to a customer in the public sector, the agency is liable for PAYE/NIC where IR35 would otherwise apply to the PSC.

This has caused some consultants to exit work in the public sector in favour of the private sector where PSCs remain responsible for their own IR35 assessment.

HMRC issued a consultation in May 2018, proposing to extend the public sector rules so that agencies would be liable for PAYE/NIC whether the customer is in the public or private sector.

Total tax and NIC at different levels of gross income



Source: Deloitte analysis

If implemented, those agencies with large numbers of PSCs will need to consider charging more for the additional tax compliance burden. This may present an opportunity for agencies where customers currently engage PSCs directly, and going forward do not want the PAYE/NIC obligations themselves and instead choose to push those PSCs down to agencies. On the other hand, VAT on agencies' fees will increase, due to them being liable for employer's NIC, causing an additional hard cost for clients who cannot recover VAT in full. Businesses wanting to avoid that cost may want to engage PSCs directly given, in this case, as the employer's NIC is the client's own liability, the PSC will not have to charge VAT thereon.

There is a current debate on whether the new proposals would be likely to commence from April 2019 or 2020. The former would more quickly address a claimed £1.2bn tax gap from non-compliant PSCs. However, there is a lot for the private sector to do in readiness and allowing businesses a longer lead time will help to mitigate potential compliance failures. The new rules pose many risks for businesses, and there is plenty that can be done now which will be useful preparation for whenever the proposals go live. We recommend businesses put this high on the agenda to avoid being caught out.

NMW underpayment

The underpayment of NMW is a key focus area for HMRC and many businesses do not appreciate the complexity of the rules and how they are interpreted by HMRC. Material liabilities can arise, caused by both having to pay the historic NMW shortfall to workers, and because of fines of up to 200% of the underlying liabilities. There may be also uncertainty as to whether this cost can be onward invoiced to the relevant end customer.

Working practices can put agencies on the wrong side of NMW legislation, such as performing mandatory security searches of workers, the requirement for workers to wear uniforms, complete training or compulsory attendance at team briefing meetings outside standard working hours and not paying workers for this time or expenditure.

What can you do as a lender?

NMW

Ask how the business has addressed the recent increase in NMW in its forecasts?

Ask does it have the ability to pass on additional costs to the end customer?

Ask how robust are the customer's internal controls regarding NMW procedures.

HMRC correspondence and claims

Ask for any correspondence to/from HMRC and in particular any unresolved claims made or ongoing investigations.

Understand whether there are any provisions for claims which are on the balance sheet.

Forecasts

Understand the impact on margin, profitability and cash flow as a result of changes in legislation.

PSCs

Understand if the temporary labour agency engages people to end users in the public sector and the impact from changes to the IR35 rules in 2017.

Consider the potential impact of any extension of these rules to the private sector.

Professional advice

Seek appropriate advice regarding diverse and complex tax issues.

Profitability and creditworthiness

There is a paradox at the heart of the multi-billion pound business of lending to the temporary labour sector. Lenders may be generally happy to lend against invoices, especially those raised against blue-chip customers, such as large multi-national businesses. But are these agencies as credit worthy as they seem?

Constant pressure on margins (and profitability) is a notable feature of working in temporary labour.

There is little to stop new rivals from emerging. Barriers to entry are generally low and even when there are restrictive covenants designed to prevent existing employees from establishing rival agencies, these are usually ineffective in terms of deterring people from setting up in competition.

Indeed, in some cases margins are non-existent or even negative. It is not unusual to find agencies working on loss-making accounts.

Lenders tend to focus on the quality of debtors with the underlying financial performance of a contract a secondary concern. Management information may be insufficiently detailed for lenders to conclude accurately on profitability.

It is of key importance that the temporary labour agency can articulate the profitability of its contracts. Lenders should expect regular financial analysis to support this.

Why would temporary labour agencies operate loss making accounts?
There are a number of possible reasons:

1. In the case of an owner-managed business, the owner may see revenue as the true gauge of business success and be reluctant to surrender even loss-making contracts.

2. Some agencies, whatever their ownership structures, are keen to prevent a rival winning the business, even if it is unprofitable. An existing agency may wish to prevent the rival from attaining a certain size, or because it believes that, given time, it can make the work profitable. Or it may believe the unprofitable account could lead to other, profitable, contracts.

3. Some agencies may underbid to win contracts. Agencies may pursue business size at the expense of profit, for reasons of simple vanity or, more rationally, in order to gain greater brand exposure. This is sometimes seen in the retail sector, where unprofitable stores are kept open for this reason.

4. Contracts may have been mispriced in the first place, with a lack of understanding as to all the costs involved in servicing the accounts. Agencies incur both direct costs (wages due to the temporary workers), but also general overhead costs specifically relating to the contract, such as transport, security checks for workers etc. The loss of control of the latter (or a lack of understanding of the costs for each customer) can often prove to be the difference between profit and loss.

Profitability of businesses in the sector

Agencies specialising in providing blue-collar workers often prove to be less profitable than those supplying white-collar personnel.

Margins are thin in blue-collar work, as would be expected in a field characterised by workers with low skills, minimum-wage levels of pay and a plentiful supply of labour.

In white-collar or niche work, higher skill levels and a more restricted pool of people possessing them, result in higher pay and higher margins.

Our analysis of the reported operating margins for temporary labour businesses shows a high concentration with revenue ranging between £10m and £100m and margins between one and five percent of revenue. By comparison, permanent recruitment businesses have much higher margins (30–50%), albeit much reduced revenue levels, evidencing the differing business models.[11] This analysis is based upon publically available financial results filed by businesses within the last 18 months.

Latest period operating margin

Source: Company Watch and Deloitte analysis

One response from blue-collar agencies is simply to increase in size, hoping to unlock economies of scale, given that these are scalable operations in which the operator needs only the core head-office function, and perhaps a small branch network, on to which new customer contracts can be bolted.

Should this growth strategy prove to be successful, the agency concerned may join that group of very large temporary labour agencies that are able to operate on low margins, effectively dictating a low rate of profit to the whole industry. Smaller agencies sometimes fight back by diversifying into niche areas or by trying to add value/offering wider services.

Should it not be successful the agency may be faced with insufficient contributions from its contracts to cover its overhead base and debt service obligations.

Other factors impacting profitability

- The 'cottage industry' aspect of much of the sector can blunt the urge to increase profits. A high proportion of agencies are privately owned and need to make just enough money to support the lifestyle of the owner-manager.

- Many temporary labour agencies are over reliant on seasonal business and the pattern of an agency's takings is likely to mirror that of the sector it serves. For example, an agency working for the retail sector may make most of its profit in the fourth quarter of the year. Many agencies only make a profit in these peak months. Should forecasts not be met this could lead to future cash issues.

- The buying power of big customers remains perhaps the most pervasive factor behind low margins. Big companies have, in recent years, received negative publicity for their treatment of suppliers, and in an attempt to avoid further criticism, companies may refrain from imposing excessively onerous terms on agencies.

- With a likely reduction in the number of workers from European Union countries as a result of Brexit, there may be an increase in temporary workers' pay as supply reduces. If those additional costs cannot be passed onto customers there is likely to be detrimental impact on agency margins.

Smaller agencies sometimes fight back by diversifying into niche areas or by trying to add value/offering wider services.

What can you do as a lender?

Assess the proportion of blue-collar work in the temporary labour agency's order book, given this is less profitable than placing white-collar workers.

Look for any positive sign that the temporary labour agency is seeking to add value to improve margins.

Compare revenue with profit for indications that business size is being pursued at the expense of margins.

Challenge the margins quoted for each contract by ensuring that all the direct overheads have been factored in – understand the contribution from each contract, not just the gross margin.

Understand if the business is reliant on seasonal demand and how the agency will meet that demand.

Check clauses/Brexit clauses to see if the temporary labour agency can pass pay rises for workers onto the end customer.

Check to see if there are any Brexit related clauses in contracts.

Take a closer look at the management team – are they qualified, do they hold accounting or business qualifications? Has the Board got the appropriate structure and skills?

Holiday pay

Holiday is accrued by the worker on a pro rata basis by hour and charged to customers on the same basis. The nature of the temporary workforce and regular restrictions on available holiday periods mean agencies typically accrue a liability to workers for unpaid holiday pay.

When temporary workers take holiday, the temporary labour agency faces a "double" cash cost, as it pays the weekly wages of the temp on holiday and the replacement at the customer whilst receiving the income for one worker.

Upon transfer of a contract to an alternative agency, industry practice dictates that the outstanding liability to the temporary workers (who transfer to the new agency under TUPE) is settled by the outgoing agency prior to the transfer. These liabilities can be significant and place increased pressure on working capital and cash flows.

If a temporary worker voluntarily leaves an agency, any outstanding liability should be settled through their final payroll. However, in many cases, temporary workers may not immediately claim their holiday pay, or know their entitlement to it. Should this holiday pay remain unclaimed for a period of time, some agencies release this liability provision, effectively improving their reported profits. It appears some agencies may choose to provide for only an anticipated percentage of holiday pay claims by departing temporary workers – effectively assuming a profit improvement within their contract performance and potentially understating the balance sheet liabilities.

What should you do as a potential or incumbent lender?

Lenders should be focused on holiday pay dynamics. In the event of an insolvency and break up of a business, holiday pay may impact the recovery from debts if customers seek to make deductions for the outstanding liability. However, if two lenders are competing to lend to an agency and one is asking about holiday pay (and potentially provisioning for it) and the other is not, then the former is at a competitive disadvantage.

Checklist for lenders

Ask what the holiday pay liability on the balance sheet is and how it has historically varied month by month.

Understand what accounting policy is in place for holiday pay.

Ask what happens to holiday pay when temporary workers leave the company.

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Macroeconomic outlook and Brexit

Business has been booming for the temporary labour industry, with the value of the sector estimated to have risen by about £2.5 billion between 2016 and 2017.[2] That is not surprising, given the buoyancy of the labour market.

Economic outlook

However, how might an economic slowdown impact this sector? Typically, a loss of jobs is the early sign of a slowdown. Temporary jobs are often the first to be cut. If an employer has 80% of its workforce employed permanently and 20% temporary, they will cut temporary workers first.

They would suffer first as:

- Businesses do not have to find redundancy settlements and the 'flexibility premium' paid with regard to these workers means they are slightly more expensive than their own employees; and
- The loss of these jobs would not necessarily make headlines in the same way as cuts to the directly employed workforce.

Temporary labour agencies would no longer be required to supply as many people and revenues and profits would suffer.

Brexit

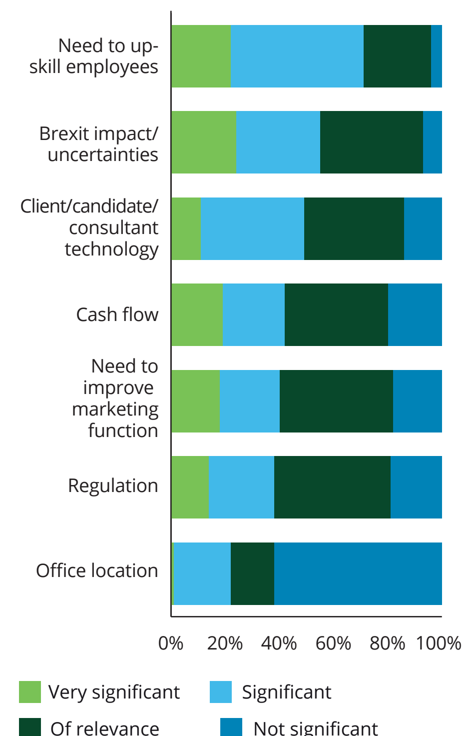
Brexit is another source of uncertainty.

A so called hard Brexit in terms of future trading arrangements could trigger (or deepen) the sort of downturn that many fear may happen anyway.

Secondly, future immigration arrangements may shut off key sources of supply for temporary labour agencies, such as from members of the European Union. In addition, the decline in sterling's exchange rate since the June 2016 referendum has made the UK less attractive to European Union workers, given earnings will be worth less when translated into their home currencies.

With a reduced supply of workers, agencies may struggle to meet their customers' demands, particularly in the peak fourth quarter of the year which is vital for retail. This will result in reduced revenues and profitability and exiting peak periods with lower cash surpluses which are often required to cover the loss making periods in the year.

Participants' views on the significance of various barriers to growth



Source: The Deloitte 2017 Recruitment Index in association with APSCo

Deloitte's 2017 Recruitment Index found that respondents saw Brexit as one of the key barriers to growth. 55% of respondents rated Brexit impact/uncertainties as a significant or very significant barrier to growth.[1]

If faced with a reduced supply of workers post Brexit, temporary labour agencies may struggle to meet their customers' demands, particularly in the peak fourth quarter of the year which is vital for retail.

The largest number of European Union workers are concentrated in sectors which contain a relatively high proportion of temporary workers, being wholesale, retail, hotels and restaurants (together accounting for approximately 508,000 people).[12]

The next largest sectors (financial and business services) are generally less likely to hire temporary workers, because of both the professional qualifications required and the greater likelihood that people will seek to build long-term careers. Together they account for 382,000 European Union workers.[12]

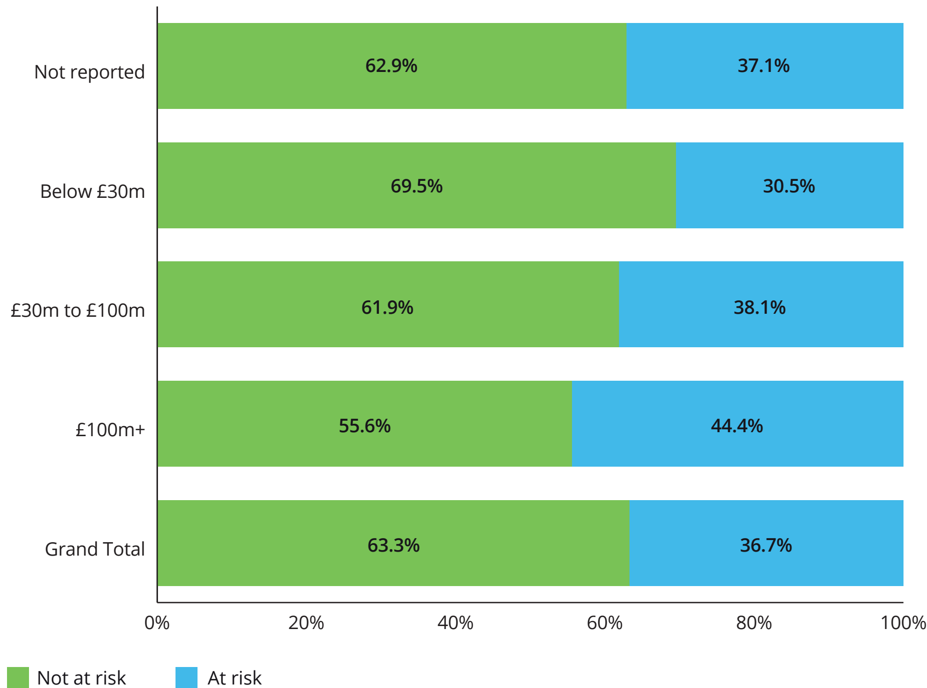
Interest

Borrowing costs are expected to rise, however slowly. The official Bank Rate has been at record lows since March 2009, and a tentative first step has been taken in terms of moving them back to more traditional levels. Temporary labour agencies tend to be highly leveraged, thus sensitive to rate rises.

This may impact the survival of 'zombie' companies. In January 2018, the UK's insolvency and restructuring trade body R3 estimated that 49,000 firms fell into this category.[13] The question arises of how many temporary labour businesses fall into the 'zombie' category.

Zombie companies
Unviable businesses which are kept artificially alive on money borrowed cheaply and low interest rates.

Risk of failure of UK temporary labour businesses by revenue category



Source: Company Watch and Deloitte analysis

Risk of failure

Based upon Company Watch's "H-Score" algorithm (which seeks to determine from publically filed company accounts the risk of financial failure of a company in a range of 0 to 100), we have analysed the UK temporary labour sector by revenue category. This shows that those with revenue of more than £100m have a higher chance of failure (44%) compared to the overall chance of failure.[14]

This is likely driven by the fact that many of the businesses in this revenue sub-category are growing rapidly which, if not controlled and managed, can lead to cash constraints and financial difficulties.

Transline: a case study

Both typical – and one of a kind

Every temporary labour agency is different, as are the circumstances under which some of them encounter financial difficulties. That was the case with the insolvency of Transline, for which two partners of Deloitte acted as administrators. However, it also illuminates some issues common across the industry.

Based in West Yorkshire, Transline had revenue of £214 million in 2016 with more than 10,000 temporary workers and employees at locations across the country at its peak.[15] It supplied temporary workers to the logistics, warehousing and manufacturing industries. In many ways, Transline was typical of mid-sized temporary labour agencies, being owner managed and, arguably, insufficiently quick to respond to changing circumstances. In addition, it did not fully understand the profitability of its contracts once all the costs involved had been taken into account.

Another common industry problem was the added pressure on margins arising from a significant tightening of the rules by HMRC with regard to tax-advantaged schemes relating to travel and subsistence for temporary workers.

In other ways it was quite untypical in an industry with a generally low public profile in that it had been the focus of recent and extensive media coverage.

In 2015 Transline was one of two agencies which faced media allegations over criticism of working conditions and underpayment of the NMW at the site of one of its customers.[15] It survived that immediate storm (albeit placing cash pressure on the business due to the need for backdated NMW payments) but in early 2017 its problems rapidly multiplied.

The retail sector, which Transline relied heavily on, achieves seasonally high revenues in the final quarter of the year driven by Christmas.[15] In the quarter to Christmas 2016, Transline had been unable to maximise this position and, by March 2017 was forecasting a funding requirement. Couple this with the termination of a customer contract worth approx. £35 million revenue (16 per cent of the total) and the position was of significant concern.[15]

In response to the issues facing it, the management team sought assistance from a non-executive chairman, its lenders and financial advisors.

Temporary labour businesses typically have limited assets (aside from book debts) to support secured debt raising. With all its assets encumbered, the size of the funding requirement prohibited raising additional financing to allow the business to trade through challenging times. The shareholders were also unable to invest further funds. A turnaround of the business was also considered, by driving profitability with margin improvements with certain customers and cost reductions, but this presented too much uncertainty over too long a time period and would not resolve the immediate cash flow challenge.

Consequently, in order to ensure business continuity and maximise returns to creditors, it was imperative to conclude a rapid transaction to save the trade of the business.

Financial and distressed investors were deterred from investing due to a number of reasons including the loss of customers. They were also deterred by the low margin nature of contracts supplying into the blue-collar sector.

The contracts contained no real security or protection on the transfer of ownership, meaning that customers could have ultimately changed supplier. The negative press and stigma attached to the business from historical trading activities was a significant barrier to investment from financial investors – many of whom deem positive PR as a critical condition of any acquisition.

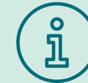
Trade purchasers saw the acquisition as having greater appeal, acknowledging the potential to "bolt-on" the contracts to their existing business and leveraging their expertise to increase profitability. Trade purchasers focussed in much greater detail on costs and profitability associated with contracts, holiday pay and TUPE liabilities (an area of potentially significant value) and the strength of customer relationships.

These relationships were tested over the two months leading up to the transaction as customers became aware, through press coverage, that the business was seeking a new financial backer to invest in the business (and later that it was intended to appoint administrators to the business). This uncertainty led to further attrition in the customer base, re-shaping the business to around half its original size. This widened the number of potential purchasers, making the "bolt-on" acquisition more accessible to similar mid-sized agencies.

One such agency was able to conclude the transaction and acquired the majority of the trade and assets of Transline through a pre-packaged administration.[15] This ensured continuity of supply to customers and preservation of all jobs (more than 5,600). Any further customer losses would have likely made the business, as a whole, unsaleable.

Key points
The events illustrate how media attention can bring significant additional challenges when trying to find investors or buyers for a troubled temporary labour agency.

They flag some structural weaknesses present in many agencies which we have flagged in this report, regardless of whether they are in financial trouble, namely low margin contracts and a high ratio of debt to assets. It also highlighted the need for strong controls and focus around all aspects of temporary workers, including the TUPE position, being aware of "inactive" workers who remain workers when not placed at customer sites, outstanding holiday pay liabilities, the inability of owner managers to invest and a need to keep talking to customers during any restructuring.



What can you do as a lender?

The case underlines the need to act quickly and to seek expert professional restructuring advice at the earliest stage to:

Provide restructuring support.

Review a short-term cash flow forecast.

Review medium term financial forecasts.

Undertake options analysis.

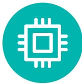
Undertake contingency planning.

Run an accelerated sales process.

New challenges and opportunities

Market disruptions

There are new headwinds which create fresh challenges and opportunities which result from an increasing trend in the use of new technologies and automation (and artificial intelligence) of processes. Meanwhile, flexible working has become more common in the UK, particularly since the recession. These factors will impact demand for talent and offer opportunities as well as challenges.



1. Technology:
Most recruitment businesses see technology as being a key driver of growth however the use of analytics remains low. Whilst digital technology companies grew at three times the rate of the economy in the past year.[16]

Businesses which apply new technologies and innovate could become more competitive by becoming more efficient and reducing the time required to complete a task (and therefore the associated cost).

Those who have better sources of data may also be able to improve customer relationships.

2. Automation:
Automation is increasing across all sectors and temporary labour providers need to be alert to the sectors they are supplying into.

It is estimated 35 per cent of UK jobs are at risk from automation in the next 10-20 years.[17]

Roles in the blue-collar sectors such as picking, packing and shipping in warehouses or in construction are sectors which are reliant on temporary labour and could be at risk from automation.

Increasing automation may change customer requirements. Agencies need to be able to adapt to those changes and work with their customers to meet their demands.

3. Flexible working:
We've commented on the rise of the gig economy and the shift towards more flexible working. Increased flexibility has helped the growth in part time employment and the growth in demand for temporary work.

The flexibility now extends to the way talent is sourced and the skills of people, not just meeting demands for more flexible working patterns. Agencies need to ensure they have access to the right people to meet their customers' demands.

Market disruption – the future?

What is to stop temporary workers cutting out agencies altogether and looking for work directly?

Skilled people will be able to put themselves in front of potential customers in an electronic format, giving a detailed picture of their skills and experience. This will not mean the end of agencies – far from it.

Those agencies that embrace technology will be more successful. Operators, owners and lenders alike will be aware that this requires investment and funding. The challenge with this is the typical absence of assets that can be leveraged to provide the investment. Investment also requires returns and, given low margins in temporary labour, investment returns are deemed to be low.

Technology may drive huge change, but agencies "do not just find a worker", they source workers, manage and train people, transport teams to their jobs, manage seasonal demand, handle payroll and associated administration. Without agencies, customers would be faced with dealing with these tasks.

New challenges and opportunities

Sector specific considerations

Whilst the headwinds described apply to all agencies, there are other sector specific factors which will affect agencies supplying the sectors:

Healthcare – Agencies specialising in medical and healthcare personnel are feeling the fall-out from the cap imposed on fees in October 2015 from the National Health Service. During the 12 months that followed, agency revenue from the NHS fell from £3.6 billion to £2.9 billion.[18] The sector has also been impacted by the amendment to IR35 from April 2017 where workers are supplied by a PSC to the public sector (as explained earlier).

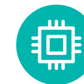
Oil and gas – Suppliers linked to oil and gas have shared the difficulties of companies in that sector as the oil price dropped and, consequently, offshore activity was greatly reduced.

Retail – Traditional retail is struggling under the pressures of increasing online sales and decreasing store sales, as well as increase in living wages and business rates. A number of retailers have already started to rationalise their store networks, whilst e-tailers continue to perform well. The combination of these factors leads us to predict more retail restructuring over the next 12 months. Our report on the future of the UK secondary shopping centre market explored the effects on this sector and how investors and lenders may react to the new challenges.

Social care – A ruling in 2017 found social care workers who "sleep in" as part of overnight on call shifts should be paid the NMW for those hours (rather than a flat rate). Where companies have not paid workers the NMW for those hours, they could have been faced with a significant bill for arrears. The Government introduced the Social Care Compliance Scheme in November 2017 which care employers could opt into, giving them a year to self-review and identify what they owe workers and then three months to repay any arrears (by 31 March 2019 at the latest). However, the Court of Appeal ruled in July 2018 that care providers had no liability for arrears. It remains to be seen whether this ruling will be appealed.

There are bright spots. We explained earlier there are opportunities for better margins for agencies supplying into white-collar/niche sectors.

There are growth opportunities in a number of sectors where M&A activity is also buoyant:



Technology – There is a shortage of technology staff (including in cyber security). Agencies that are able to satisfy this demand will be well placed to charge better margins.

Infrastructure and life sciences – These sectors are amongst the other end user markets where demand is strong and opportunities for growth exist.

New challenges and opportunities

Actions

Working to tackle challenges faced by temporary recruitment agencies

Agencies are facing what can seem to be an endless wave of new regulations and a struggle to maintain profitability. Agencies and those who advise companies in the sector should seek specialist advice when faced with challenges and opportunities.

Lenders

Lenders need to be aware of the key challenges set out in this report, understand how these are impacting their customers and be ready to act on them.

We have highlighted through the report actions to take, questions for lenders to ask and information to request from customers.

Directors/management teams need to grasp the fragility of a temporary labour agency that has trading challenges and the imperative to move fast. Lenders need to act quickly on signs of stress and request professional advice, working collaboratively with the temporary labour agency.

How can we help businesses and their stakeholders face the challenges?

1. Sourcing capital: Request support to help source capital for both high-performance and stressed businesses or to support in refinancing debt.

2. Due diligence support: Seek due diligence services for those acquiring or investing in temporary labour agencies.

3. Restructuring support: Engage restructuring experts to help agencies or stakeholders with:

- Cash flow support/review short term cash flow forecasts;
- Review of medium term financial forecasts;
- Scenario/contingency plan; and
- Assess and develop options available for the business.

In times of financial stress, positions can quickly unravel and advice should be sought immediately.

If a temporary labour agency cannot pay its workers they will go elsewhere and customers will stop paying.

4. Sale or acquisition: Engage experts to provide specialist advice on mergers and acquisitions.

If the position requires a quick sale, we can assess sale options to trade or financial parties or run that sale process.

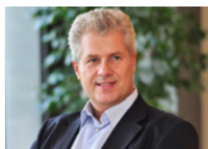
5. Specialist tax advice: Request specialist advice to gain an understanding of the specific tax implications:

- Sector specific employment tax/VAT issues – Advice in respect of different contracting models, due diligence exercises, HMRC negotiations etc;
- Assess historic/ongoing compliance with NMW requirements (before a potential HMRC investigation or support during an investigation and liaising with HMRC); and
- Help with understanding the employment status of temps and highlighting the impact of each status.

Contacts

Clare Boardman
Partner, Financial Advisory – Restructuring Services
cboardman@deloitte.co.uk
+44 (0)113 292 1744

Katie Folwell-Davies
Partner, Financial Advisory – Human Capital Services Lead
katiefolwelldavies@deloitte.co.uk
+44 (0)20 7007 3645



Mark Groom
Partner, Tax
mgroom@deloitte.co.uk
+44 (0)20 7007 2770

Sector experts

Chris Hirst
Director, Financial Advisory – Restructuring Services
chirst@deloitte.co.uk
+44 (0)113 292 1919

Sohail Ahmad
Director, Financial Advisory
soahmad@deloitte.co.uk
+44 (0)20 7007 2263

Mark Burton
Assistant Director, Financial Advisory – Restructuring Services
marburton@deloitte.co.uk
+44 (0)121 695 5314

Dominic Haslam
Associate Director, Tax
domhaslam@deloitte.co.uk
+44 (0)113 292 1196

James Reddington
Manager, Financial Advisory – Restructuring Services
jreddington@deloitte.co.uk
+44 (0)113 292 1862

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