Professional Services Sector

Recruitment Sector Covid-19
Survey Insights

HSBC UK

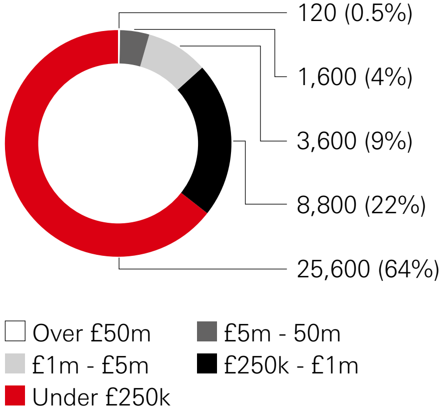
Introduction

Recruiters are an economic barometer due to their exposure to a range of industries, both public and private. In 2019, the UK's Brexit impasse and planned IR35 changes, French strikes, German manufacturing slowdown and even Australian wildfires were all cited as reasons for subdued performance by recruiters in affected markets. Whilst Covid-19 has caused recruiters to forecast a 15-30% income drop this year, logic suggests that such events made the sector a little more resilient going into the crisis, and as we will discuss there are a number of opportunities in the post-Covid environment.

Recruitment market overview

HSBC's Professional Services team has recently conducted a survey of our UK-based recruitment clients and contacts to understand the impact from Covid-19, and their perception of the longer term changes it might bring. Firstly, it is important to understand the structure and recent drivers of the UK recruitment market which grew 9% to £38.9bn[1] in the year to April 2019 vs 11% growth the previous year. The market has for the last few years been consistently 86% focused on 'temp' and contract staffing vs permanent placements at 14% of the market, both typically seeing firms achieve 15-20% profit margins. The industry is fragmented with the 10 top firms holding only 26% market share by revenue which compares to an equivalent 40% in the legal market and – to the concern of the Competition and Markets Authority[2] – 75% for the top 4 firms in both the accounting and property services sectors.

UK Recruitment Sector
Firm numbers and Revenue, c.40k firms



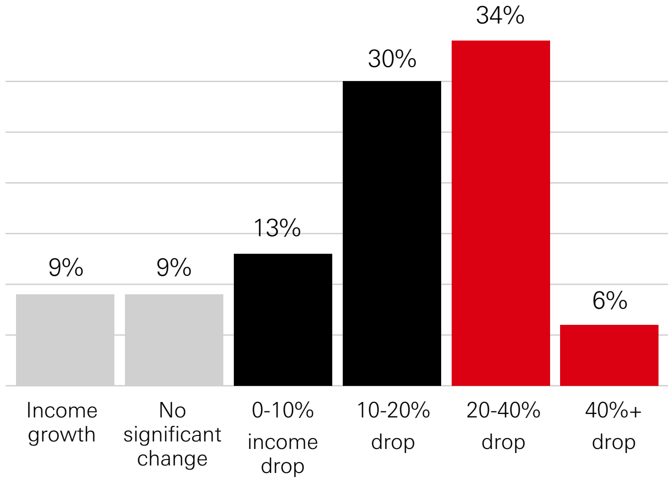
[1] REC Recruitment Industry Trends Report 2018/19 [2] Statutory Audit Services Market Study – Final Report, CMA, 18 April 2019

> **"85% of firms using the income tax and VAT deferment schemes."**

UK fundamentals and a global view

Between 2015 and 2018, there was strong growth in the number of UK recruitment firms due to; the UK's high rates of contract workers,[3] churn in the labour market, a resilient open economy, light regulation, consistently low unemployment, and staff shortages notably in education, healthcare and engineering sectors. This increase in firm numbers slowed in 2019 due to the natural capacity of the market as much as Brexit uncertainty. Even before Covid-19 it was clear that <£1m turnover firms would need to invest in their technology platforms to compete, and as confirmation, our survey suggests consolidation is now more likely. On a global view, the UK recruitment market is second only to the US in terms of global revenue share (36% and 13%) with Japan (11%) and Germany (9%) next in size; a position due to market fundamentals and not likely to be significantly affected by Brexit or Covid-19.

Recruitment Sector Covid-19 Income drop forecast FY20/21
(% survey responses)



Reassuringly, the sector is well known for its flexible cost base and 80% of firms stated that their initial action on staff and remuneration was sufficient, prompt and at the right level. Excluding staff costs, 60% of respondents have made monthly cost savings of up to 20% compared to previous commitments, with the remainder achieving even greater savings. Furthermore, it appears UK Government support has been key with 85% of firms using the income tax and VAT deferment schemes and nearly 40% using one of the Coronavirus Business Interruption Loan Schemes resulting in the majority of firms (75%) considering they are 'likely to be able to operate within existing financial arrangements'.

However, contrary to the cost savings thus far, 75% of firms stated they had not cut consultant or key biller commission due to the Covid-19 impact and this may be due to the continuation of Government support, perhaps inferring a very different response once such measures come to an end. Worryingly, nearly half of firms considered furloughed staff would be made redundant with one commenting that it was an opportunity to change out under-performers in order to hire new staff. On a positive note for governance, it appears that over two thirds of firms have cut executive management profit distributions in FY20/21, albeit there remains headroom for further cuts if needed.

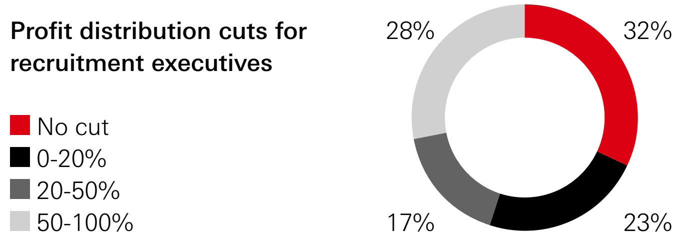
Our survey insights

Comparing recruitment firms can be trickier than in other sectors due to the variation in exposure to different industries and their 'perm-temp' or 'public-private' sector mix. However, Covid-19 has been a shock to all and our survey conducted in the first 2 weeks of July provides a few useful insights. 80% of the respondents were in the £5-£100m revenue bracket with majority exposure to private sector and an equal mix of perm/temp sales. 50% had exposure to IT, financial and professional services clients whilst 40% achieved sales in construction, manufacturing, infrastructure and heavy industry. This mix therefore appears well balanced and indicative of the wider UK recruitment market.

Financial insights

The headline of most interest to recruitment executives is that over 80% of firms expect a drop in income for full year 20/21, with the majority viewing a 15-30% drop as likely vs pre-Covid income. Clearly this forecast is relatively early in the financial year and if the economy stabilises with no second lockdown, then there is every reason to suggest firms can beat their predictions. Indeed, our regular engagement with firms has already seen a softening on April forecasts, but this will be under close scrutiny. One CFO stated that they suffered a 'larger erosion of revenues due to IR35' changes planned last April although how true that is for the wider market is unclear.

Profit distribution cuts for recruitment executives



[3] 5.3% Temporary employees as a % of UK 'employee' workforce, ONS Q1-20 data. Consistently first worldwide vs NL: 3.3%, Aus: 2.7%, Jpn: 2.4% US: 2%. The underlying driver for the UK's significant lead is the high income tax making contract work favourable. IR35 regulation, delayed to Apr-21 will reduce this lead in the years ahead.

> **"We are definitely seeing some positivity returning to the market – our monthly professional trends survey, which we undertake in conjunction with cube19, has shown an increase in both contract and permanent vacancies for the second month in a row. Perm vacancies were up 18% in July compared to June and contract roles were up 14%. Year-on-year activity is down by around a third for both contract and permanent roles but we are seeing this percentage gap decreasing each month suggesting that we are heading in the right direction."**
>
> Ann Swain, Chief Executive, APSCo

The long view

When considering the impact that Covid-19 will have on the recruitment sector 3 years from now, firms considered consolidation was likely and that temporary/gig economy work would increase more than permanent placement activity. 75% of respondents stated there was now a reduced need for office space as remote working has now been proven, with many thinking that 20-50% of staff working remotely longer term was likely.

Going abroad

Consensus on geographic ambitions, whether firms should diversify and internationalise rather than focusing on home markets was rather less clear with a slight favour for continuing the recent trend of growth abroad. This would appear a sensible strategy for those wishing to off-set any Brexit risk and is in tune with a new age of 'Global Britain'. However, venturing abroad is not without its challenges in understanding the market and competition, following regulations or finding a suitable local firm for an acquisition or joint venture. HSBC has a substantial global network and we regularly make cross-border business introductions to help business leaders explore the opportunities and risks associated with any new venture.

Legislative structural support

Any significant Government interventions to kick start the economy should feed through to recruiter activity, even if the unemployment rate ticks up in the coming months.[4] The deferment of IR35 legislation to April 2021 was welcomed and incentives to upskill workers via the apprenticeship levy and recent investment announcements on infrastructure, education and healthcare should all be a boost for the recruitment sector that is driven by churn more than the unemployment rate. In countries where temp/contract work is not as pervasive as in the UK, a relaxation of employment rules is an easy way to encourage the activity, a measure being now considered by the French Government.

Recruitment sector M&A

The market fundamentals described earlier have made recruitment a buyer's market in recent years and Covid-19 is likely to accelerate this trend. We spoke to Steven Raize, Corporate Partner at Gateley Legal, who focuses on M&A in the recruitment sector. He highlights that there has been a resurgence of interest from investors and owners in recent weeks to progress transactions that were paused during the lockdown period. Recruiters with exposure to tech, healthcare, bio-tech, education and IT are likely to 'benefit' from the Covid pandemic, and more broadly any recruiter that can demonstrate good financial management and cashflows through the Covid-19 downturn will be an attractive target based on the logic of 'survival of the fittest'.

For a potential acquirer, the challenge of valuing a recruitment business has only increased with Covid-19. Steven says: "we are likely to see the use of more prolonged earn outs, say over a period of 2-3 years, or perhaps more partial exits which became common following the financial crisis in 2008." This is where owners initially sell around 51% of their shares to an investor, with the balance being subject to a series of put and call options exercisable at some point in the future. The seller is therefore able to de-risk and take cash off the table, but also benefit from any future value growth when they sell the balance of their shares at a later point.

The case for post-Covid productivity gains

If the work from home revolution proves as dramatic as many now believe this may encourage greater churn in the labour market. An accountant in Barnstable or Melton Mowbray was unlikely to consider jobs in London in previous cycles. However, if attendance at the office is more flexible this opens up many opportunities. This means potentially more churn once confidence returns, and it may also play into the hands of larger, more geographically spread recruitment businesses. The pandemic has also forced more recruiters to conduct interviews online which should reduce the time-to-hire, and should enable permanent staff and office cost savings. Together these create the opportunity for structurally higher margins in the recruitment sector, albeit only once the UK and wider world actually is 'post-Covid'.

[4] In 2019 UK unemployment was at a record low of 3.8%. Recent news articles project that Covid-19 could add an extra 2m unemployed in the UK. Whilst Government schemes are designed to mitigate this, a full 2m would equate to a 10% unemployment rate (1.28m + 2m / 32.9m), a level last seen in 1992. For context, the latest pre-Covid unemployment for; Euro area 7.3%, France 8.1%, Italy 9.7%, Spain 13.6%.

“Recruitment and staffing firms are the oil of Britain’s jobs market – making it run smoothly in good times and helping it to bounce back from the pandemic. There is no doubt times have been tough this spring and summer but recruiters are flexible and resilient, as this survey shows. It has been great to see the firms the REC has been supporting adapt to rapidly changing circumstances and use their skills to help client companies and candidates alike. We know the road to recovery is a long one, but as an industry we make great work happen – and that is going to be needed more than ever before as we find our new normal.”

Neil Carberry, Chief Executive of the Recruitment & Employment Confederation (REC)

Thank you for reading! The Professional Services team will be holding a number of events and webinars for our recruitment sector clients in the coming weeks. If you have any questions on the information presented, or more specifically on a financing matter, please feel free to reach out, whether you are an existing client or otherwise.

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