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NEW THINKING FOR THE NEW NORMAL

The challenges and opportunities for UAE construction

Vol 1 | October 2017

MEED

Middle East business intelligence

NEW THINKING FOR THE NEW NORMAL

The UAE's construction market has enjoyed good and bad times over the past two decades. There have been the highs of the real estate boom that ended in 2008, the lows of the credit crunch when hundreds of billions of dollars-worth of projects were put on hold, and more recently the ongoing drive to start new projects ahead of the 2020 Expo in Dubai. With this comes the challenges of delivering projects in a low oil price environment.

Throughout all these changes there has been one consistent theme for construction companies: getting paid. Even when the construction sector has been booming, the region has had a reputation among international contractors as being a difficult market in which to get paid on time. This problem becomes even more pronounced during down cycles, when construction clients are protecting their own cash flows.

The problem of delayed, reduced and even non-payments by construction clients has become acute over the past two years as the fall in oil prices that began in June 2014 has squeezed national finances, forcing governments to implement harsh fiscal consolidation programmes.

The region-wide austerity drive has had a profound effect on the construction industry. The most obvious consequence has been cutbacks in spending on capital projects, which have meant that construction companies that had expanded over the previous three years on the back of booming infrastructure and property investments have faced a sharp fall in revenues as new business opportunities have dried up.

The subsequent squeeze on construction industry cash flow has been made all the more damaging by the endemic problem of delayed and late payments to project contractors and suppliers. Delays in client certification of completed work result in the late release of payments by clients, while contractor claims for unplanned and unpriced changes to the scope of work are more likely to be disputed by clients. Meanwhile, performance and financial bonds paid by contractors in advance of projects are not being returned in full, if at all.

Three years after oil prices started to fall, the challenges facing construction companies in the UAE show no sign of dissipating any time soon. With oil prices projected to stay at low levels for the foreseeable future, and governments focused on tight fiscal controls and radical structural economic reform programmes, the situation for contractors in the region could get worse before it gets better.

But just as the region's governments have responded to lower oil prices with wide-ranging reforms, the drop in oil prices is also an opportunity for the UAE construction industry to change and to get rid of some of its entrenched, self-harming practices.

Lower government revenues are encouraging governments to rethink how they deliver public services and, in particular, how to fund capital expenditure. Since 2014, there has been renewed interest in alternative project delivery mechanisms, such as public-private partnerships (PPPs). The change in client procurement models presents an opportunity for UAE construction companies to adapt their role, moving from being at-risk contractors to being partners with their clients and other stakeholders, investing in projects and spreading the risks through the multi-functional consortiums needed to deliver projects on a PPP basis. Through new thinking and new approaches such as this, they will be able to free themselves from their dependence on clients for payments.

EXECUTIVE SUMMARY

- The fall in oil prices has squeezed national finances, forcing governments into harsh fiscal consolidation programmes that have resulted in cuts to capital investment in projects. The lack of new project opportunities has led to a squeeze on construction industry cash flow, which has been made all the more damaging by the endemic problem of delayed and late payments to contractors and suppliers.

- Main contractors say they feel trapped between project clients that are delaying payments for work done and a supply chain that is refusing to work unless cash is paid up front. This hinders the ability of contractors to deliver projects as planned and puts them at risk of penalties for not completing work on time or to the specified quality.

- Delays in client certification of completed work is resulting in the late release of payments by clients, while contractor claims for unplanned and unpriced changes to the scope of work are increasingly likely to be disputed by clients. Meanwhile, performance and financial bonds paid by contractors are not being returned in full, if at all.

- One possible solution to the volume of claims and subsequent disputes is to use different forms of project delivery, such as design and build, where the contractor is responsible for the design, or alternative procurement methods, such as two-stage tendering. This involves bringing contractors in early to assist with developing the design and helps avoid potential claims that may occur later, before the construction contract is signed.

- The drop in oil prices is an opportunity for the UAE construction industry to reform some of its entrenched, self-harming practices. A change in procurement models presents a window for UAE construction companies to move from being at-risk contractors to being partners with their clients, investing in projects and spreading the risks through the consortiums needed to deliver projects on a PPP basis.

- The region has been slow to adopt these alternative delivery methods. Clients in the UAE tend to prefer using fixed-price, lump-sum contracts that are competitively tendered and awarded to the lowest bidder. It is unlikely that this attitude will change without a degree of intervention. In other jurisdictions, governments have spearheaded alternative procurement methods, and with payment problems expected to worsen and the number of disputes rising, now may be the time for such a policy intervention.

- One way that contractors have been able to mitigate this problem is by helping to arrange funding for projects. Over the past five years, there has been a growing trend of international construction firms assisting with arranging financing for their clients.

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THE UAE CONSTRUCTION SECTOR

The construction industry is vitally important to driving growth and creating jobs in the UAE

It is difficult to overstate the importance of the construction sector to the UAE economy. While there are no official statistics on its contribution to GDP, there are many economic indicators that highlight its importance to the broader UAE economy.

The construction sector accounted for the biggest share of employment in the UAE in 2016, employing some 1.2 million people, about 20 per cent of the UAE workforce and 13 per cent of the 9.3 million people living in the country.

Wages earned

Construction salaries in 2016 totalled AED50bn ($13.6bn) a year, about 12 per cent of the national total. These salaries are vital for the UAE economy as they are a key driver for general consumption and other economic activities.

With an estimated $112bn-worth of construction and transport projects underway in September 2017, the UAE is the second-biggest construction market in the GCC behind Saudi Arabia.

But while the Saudi Arabian construction market, with about $144bn of construction and transport projects underway, is nearly 30 per cent bigger than the UAE market, the kingdom's population of 32 million people is more than three times the UAE's 9.3 million people. On a per capita basis, the UAE has about $12,087-worth of construction and transport projects underway per person, significantly more than the $4,460 per person in Saudi Arabia.

On a project spend per capita basis, the UAE is again second biggest in the GCC behind Qatar, which has about $31,615 of construction and transport projects underway per person.

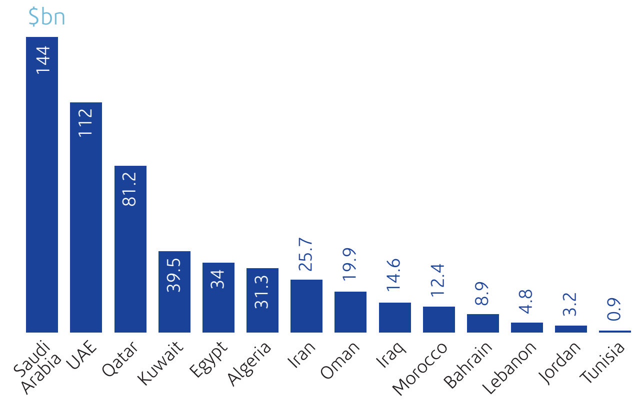
The level of construction activity varies greatly between the seven emirates that make up the UAE.

Dubai is the UAE's most active construction market, with an estimated $71bn-worth of construction and transport projects underway in September 2017, accounting for about 64 per cent of the UAE's overall construction activity.

With $28bn-worth of construction and transport projects underway, Abu Dhabi is the UAE's second-biggest construction market, accounting for about 25 per cent of the UAE total.

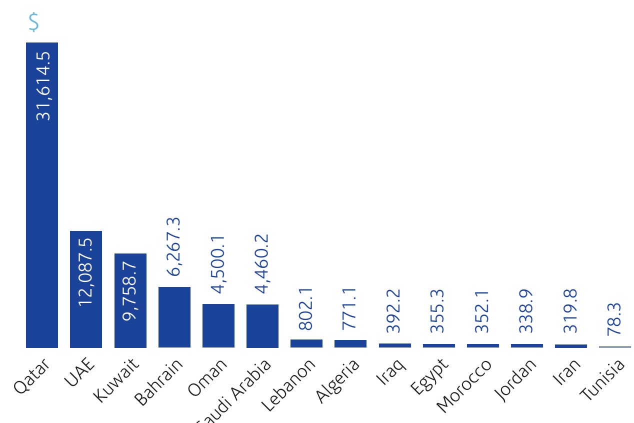
Of the remaining five emirates, Sharjah is the biggest construction market followed by Ajman.

PROJECTS UNDERWAY IN MENA REGION



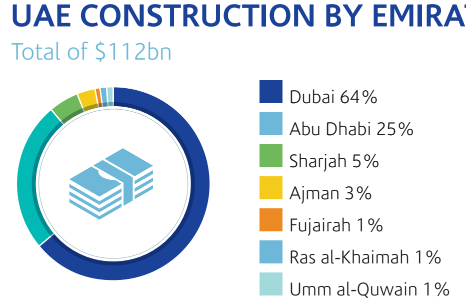
Mena=Middle East and North Africa. Source: MEED Projects, Sept 2017

CONSTRUCTION PER CAPITA



Source: MEED Projects, Sept 2017

UAE CONSTRUCTION BY EMIRATE



Source: MEED Projects, Sept 2017

BREAKING THE CYCLE

Contractors in the UAE have endured a roller-coaster ride over the past 20 years as the market has swung from record highs to spectacular lows

Over the past two decades, the UAE construction sector has experienced pronounced cycles. With oil prices at record lows and the global economy still reeling from the 1997 Asian financial crisis, construction in the UAE was in the doldrums in the late 1990s, with only a few landmark projects, such as Emirates Towers and the Burj al-Arab, brightening the landscape.

Strong growth

The down cycle turned upwards in 2003, as oil prices picked up following the US-led invasion of Iraq, and as the availability and cost of credit eased. Over the subsequent year, construction activity grew strongly in the UAE on the back of a wave of investment that washed across the region, driven by record oil prices, high levels of oil production and the easy availability of low-cost credit.

Spearheading the growth was Dubai, which in 2002 benefited from the government's decision to relax its property laws, allowing non-GCC nationals to own property in the region for the first time.

The combination of events triggered one of the greatest construction booms ever seen as investors from around the world sought to take advantage of the opportunity to invest in the GCC. A host of multi-billion-dollar megaprojects were launched in Dubai, including the Palm Jumeirah, the expansion of Dubai International airport, and Downtown Dubai with the world's tallest building, the Burj Khalifa.

By 2005, Abu Dhabi was also developing a raft of ambitious real estate megaprojects of its own, such as Al-Raha Beach, Reem Island, Yas Island and Saadiyat Island. The addition of the Abu Dhabi schemes and continued project launches in Dubai created a vast array of opportunities for the construction industry.

Boom time

The UAE's construction boom ran from about 2004 to 2008, when it was brought to a halt by the global financial crisis.

The market peaked in 2006, when, according to MEED's Project Activity Monitor (see box), the sector saw net growth in the value of construction and transport projects underway of about $33bn. Throughout this period, local construction firms and suppliers expanded rapidly, with the biggest contractors employing more than 40,000 people each during the peak years.

UAE PROJECT ACTIVITY 2004-17

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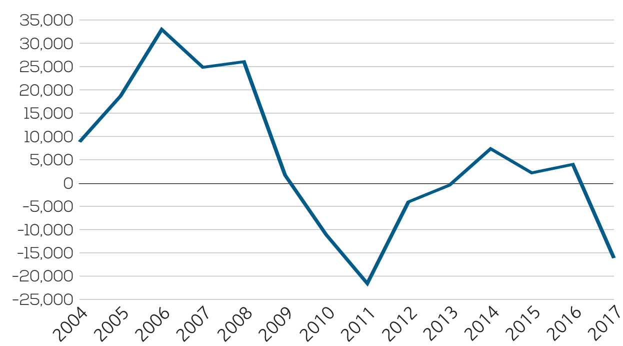


*=Project Activity Monitor index. Source: MEED Projects

PROJECT ACTIVITY MONITOR

MEED's Project Activity Monitor is an indicator of the theoretical change in order book value for a specific market and/or sector. To calculate the value, the total value of contract awards during a year is added up and the total value of projects completed during the same year is deducted. The net result indicates whether that market and/or sector is growing. A positive value means that there have been more awards than completions, while a negative value means more completions than awards. Thus, for a growing sector, the Project Activity Monitor value should be greater or equal to 0.

2006: A SELLER'S MARKET

When the market dynamic shifted in 2006, new ways of engaging with contractors had to be found

As the boom continued, the UAE construction market began to overheat with an overstretched supply chain struggling to keep pace with growing demand.

Construction cost inflation climbed into double digits and project clients started to find it difficult to attract bids when tendering projects.

Traditionally, construction clients in the region had almost exclusively tendered construction work on a fixed-price, lump-sum basis and awarded the contract to the lowest bidder.

But as the market began to overheat and demand outstripped supply, the market dynamic shifted from a buyer's market to a seller's market.

Direct negotiations

Construction clients and project sponsors had to find new ways to engage contractors in order to secure the resources needed to deliver their investment projects. Many clients began negotiating directly with selected contractors rather than tendering, and on a few projects partnering agreements were used.

The Dubai skyline in 2007

2009: THE DUBAI CONSTRUCTION MARKET CRASH

A dramatic reduction in project activity in Dubai forced companies to downsize and seek opportunities elsewhere

In 2009, just as the UAE construction industry was beginning to embrace the new ways of working in order to counter the capacity shortages, the boom turned into a spectacular bust.

By the third quarter of 2008, the UAE construction market began to feel the effects of the global financial crisis. In September, shortly after the collapse of US investment bank Lehman Brothers, signs began to appear that Dubai's construction market was heading for a crash.

Property sales in the emirate had slowed and developers were no longer able to sell large volumes of property off plan to speculative investors. By November, analysts began reporting that property prices in Dubai and Abu Dhabi had done the unthinkable: they had dropped.

Radical rethink

Prices in both emirates had fallen by about 5 per cent over the previous month. Over the fourth quarter of the year, property prices in Dubai crashed by about 23 per cent.

Developers were forced to rethink plans as high-profile projects were put on hold. One of the first casualties was the Trump Tower project on the Palm Jumeirah, which was being developed by a local firm with the US' Trump Organisation. Other flagship projects in Dubai, including the Palm Deira, Dubai Waterfront, the Arabian Canal and the Lagoons, followed. By 2009, Dubai developer Nakheel alone had about $108bn of projects on hold; the total value of projects on hold in the UAE exceeded $250bn.

While projects such as the Atlantis Resort, the Burj Khalifa and Dubai Metro were successfully completed during this period, the only major project to be started was concourse 3 at Dubai International airport, reflecting the strategic importance of aviation to Dubai and the ongoing growth of Emirates airline.

In a sign of things to come, payments were also a problem. In late 2009, MEED conducted a survey of Dubai's 25 biggest contractors. Among the key findings was a universal comment that clients were unable or unwilling to pay their bills. While some of the outstanding payments have been resolved either through the courts or through payment following capital increases such as Nakheel's trade creditor sukuk, nearly a decade later many of these contractor bills remain unpaid.

The dramatic reduction in project activity in Dubai forced the companies in the construction industry supply chain to restructure, downsize and seek opportunities in other markets.

Project sponsors in Abu Dhabi, which had less exposure to the ups and downs of the real estate market, continued to push ahead with projects, resulting in a shift in focus for the UAE construction supply chain towards Abu Dhabi as the new source of work.

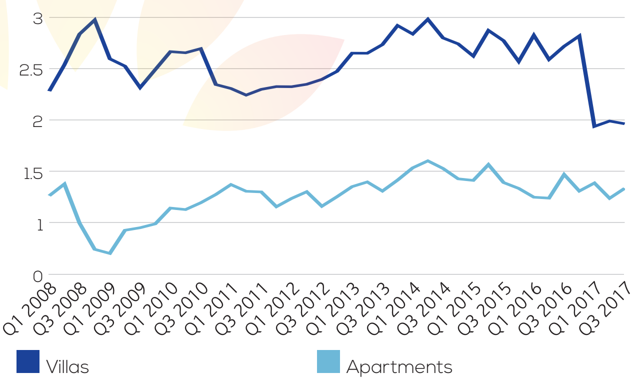
Dubai's construction industry contractors and suppliers also extended their gaze to other markets in the region that had been more insulated to volatility in the global financial system and where governments were pressing ahead with major infrastructure programmes. The largest of these markets was Saudi Arabia, which was tendering huge projects such as Jeddah airport and the one-kilometre-tall Jeddah Tower at the time.

But it was not enough to offset the Dubai real estate crash and the new procurement methods that had started to be introduced in 2007-08 were abandoned, as once again, supply capacity outstripped demand, leaving construction buyers able to dictate contract terms and conditions.

In Abu Dhabi, partnering agreements were scrapped and contracts that had been under direct negotiation with selected contractors were quickly put out to tender. With contractors desperate to replace the work that had stopped in Dubai, competition became cut throat and clients soon returned to their traditional lowest-price-wins model for placing contracts.

DUBAI PROPERTY PRICES 2008-17

Million AED



Source: Cavendish Maxwell

2011: DUBAI REBOUNDS

Much to the market's surprise, the Dubai construction sector entered a recovery amid regional turbulence

The next major change for the UAE construction market came in 2011, when, at the start of the year, Abu Dhabi's Executive Council began a strategic review of major projects. As a result, the pace of new contract awards in the emirate began to slow.

This meant that after turning negative in 2009 and 2010, the net value of construction and transport projects underway in the UAE slumped in 2011 to its lowest-ever recorded figure of minus $22.5bn, according to MEED's Project Activity Monitor.

As 2011 came an end, signs began to emerge of a recovery in Dubai's construction market. The political uprisings that had swept the region throughout the year led to an upsurge in visitors to Dubai as tourists chose to travel there rather than to destinations such as Egypt and Syria.

Energy returns

Real estate developers saw a revival in property sales and, once again, began to launch new projects. In early 2012, Nakheel and Emaar Properties launched projects such as the Palma Residences and the Address Boulevard.

Dubai also began preparing to bid for the rights to host the 2020 World Expo, an event that promised billions of dollars of investment in new infrastructure.

Property prices quickly began to rise, encouraging more developers to launch new projects. Contractors once again began winning work in Dubai.

The new awards meant that 2012 and 2013 were years of steady growth in contract awards for Dubai, offsetting the decline in activity in Abu Dhabi.

The Dubai construction market received a further boost in December 2013, when the emirate was chosen to host the Expo. Momentum started to build in the Dubai property sector, and developers launched a raft of new projects.

The resulting increase in construction contract awards meant that 2014 was Dubai's best year for contract awards since 2008. The expectation was that the activity would ramp up even further over the following six years, ahead of the Expo opening its doors in October 2020.

2014: OIL PRICE CORRECTION

After the largest ever slump in oil prices, the consensus view is that the high prices seen in 2011-14 may never return

Oil prices hit a 30-year low of just below $27 a barrel in January 2016

Exuberance over an anticipated period of strong growth came to an end in the second half of 2014, which saw one of the biggest, most sustained falls in oil prices. Brent crude had hit highs of about $115 a barrel in June 2014, before energy market fears of a growing glut in oil supplies triggered a slump with prices falling to $55.27 a barrel by the end of the year.

The oversupply fears were caused by large increases in unconventional oil production from oil shale producers in the US, which had added some 1 million barrels a day of production each year for the previous four years, as well as new capacity that was coming onstream from Venezuela and Nigeria.

The decision in November 2014 by Saudi Arabia and other Opec producers not to cut output in an attempt to price the new, higher-cost unconventional producers out of the market added further downward pressure on prices.

Downward spiral

After a brief rally in mid-2015, oil prices continued to fall, hitting 30-year lows of just below $27 a barrel in January 2016. Prices recovered through the first half of 2016 before levelling off in a price band largely between $40-$60 a barrel, where they stayed throughout the remainder of 2016 and 2017. This was despite a change in strategy by oil producers in November 2016 to boost prices by imposing caps on oil production from 1 January 2017.

With many factors putting both downward and upward pressure on oil prices, it is possible that major events could trigger large movements in either direction. The consensus view, however, is that the high prices seen from 2011-14 may never return. In addition to rising shale oil production in North America, technological advances in renewable energy sources such as solar, and the rapid adoption of more efficient consumption methods such as electric cars, mean future demand projections are softening.

DAILY BRENT CRUDE PRICES 2014-2017

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Source: IEA

THE IMPACT OF LOW OIL PRICES

UAE construction has been profoundly affected by a paradigm shift in the energy markets

The fall in oil prices since their June 2014 highs has fundamentally changed the economics of the region.

Lower oil prices have reduced government revenues, pushing state budgets into deficits. The immediate response of governments was to attempt to ride out the impact of the oil market crash by drawing on their vast capital reserves to prop up economic activity through stimulus spending. As a result, GCC project contract awards hit a near record of $177bn in 2015.

Tough cuts

But it was an unsustainable tactic and, as it became clear that there would be no short-term rebound in oil prices, finance ministries across the region started to impose tough cuts on public sector spending in order to limit rising fiscal deficits. Some of the toughest cuts in the region were made by Abu Dhabi, adding further delays and uncertainty to a construction market that had been slow since 2011.

Fiscal consolidation drives saw public expenditure, including spending on projects, slashed, and a fall in government deposits held at local banks.

The combination of lower oil prices and government spending cuts have had a direct impact on the value of construction contracts awarded in the region, but it is not immediate.

If the total value of contract awards for the construction and transport sectors in the GCC are taken for each year since 2006 and plotted against the average annual oil price, the correlation is not strong.

But when the value of contract awards is plotted against the oil price from two years earlier, there is a much stronger correlation. This time lag reflects the time it takes for an investment decision by a project client to materialise into a contract award.

The two-year time lag between large oil price movements and project contract awards also correlates with the value of contract awards in the UAE since 2006, albeit not as strongly as for the rest of the GCC. This is because the UAE's economy, notably Dubai, has been more successful at diversifying its economy away from hydrocarbons. The impact of Dubai on the UAE's projects market can be seen clearly in 2016. Based on oil prices the level of contract awards should have dipped. Instead it increased slightly.

Dubai has been successful at diversifying its economy away from hydrocarbons

THE CHALLENGES MOUNT

Tightening profit margins and poor payment terms are just some of the issues faced by contractors

The challenge for construction companies in 2017 is no longer finding opportunities. It is deciding what the best opportunities are and then securing contracts capable of delivering acceptable profit margins.

Despite the increase in construction and transport contract awards in 2016, Dubai contractors and suppliers have not escaped the operational challenges that construction companies are facing across the region following the collapse in oil prices.

Tough competition

Tender bid prices with tightening profit margins, onerous contract conditions and poor payment terms are widespread challenges facing contractors and have created significant stress on contractor cash flows and their ability to deliver projects successfully.

The issues have been amplified by heightened competition in Dubai, the region's construction bright spot since late 2014, as companies from around the region have turned their focus on the emirate in their hunt for work.

But even while Dubai offers opportunities, there is little scope for expansion as the new projects being brought to the market are largely replacing projects coming to completion. Contract wins therefore are largely replenishing contractor order books rather than driving expansion.

This phenomenon is reflected in MEED's Project Activity Monitor, which in 2017 so far shows a decline in the net value of projects underway in the market for the first time since 2012, largely as a result of the $39bn-worth of projects in the UAE that reached completion by mid-September this year. Only $22bn-worth of new contract awards have been made in the UAE in 2017.

For new awards, the UAE construction market is being led by Dubai, which continues to offer major contracting opportunities through the large programmes of work being undertaken at the Expo 2020 site, Dubai Creek Harbour, Deira Islands and Al-Maktoum International airport.

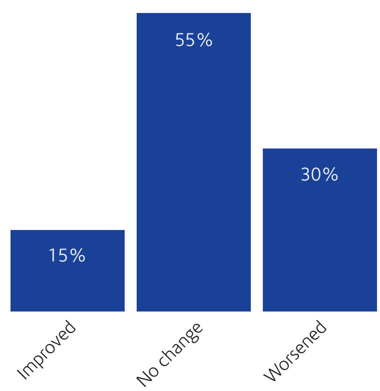
It is possible that the value of awards will close the gap on completions by the end of this year. During the summer, Dubai tendered nearly $10bn of construction contracts and, if all these are awarded and the rate of completions slows, the Project Activity Monitor will end the year close to zero.

IDENTIFYING THE INDUSTRY'S ONGOING PAYMENT ISSUES

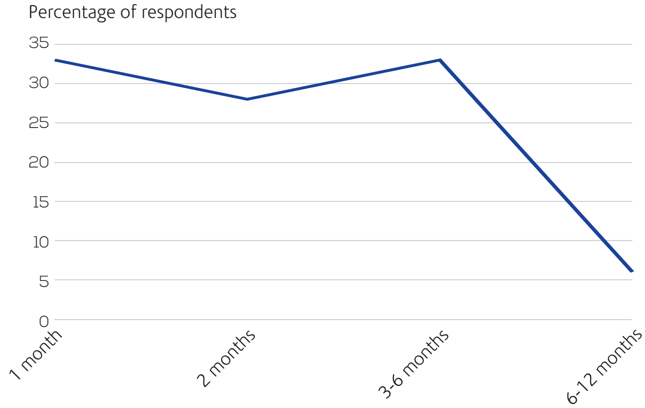
To understand the problems construction contractors are facing in the UAE, MEED in conjunction with Mashreq in July 2017 conducted a survey of CEOs, managing directors, chief financial officers and finance directors at 50 leading construction companies operating in the UAE. In addition to the quantitative data gathered by the survey, background interviews were held with selected contractors to further understand the challenges companies currently face.

UAE CONSTRUCTION SURVEY 2017

How have client payments changed over the past year?



If payment is late, how many days late is it received?



PAYMENT BLUES CONTINUE TO HURT

Contract payments can take several months to be released even in good times

Payments are a major consideration for construction firms looking for new work in the Gulf in 2017. Since early 2015, there has been growing unhappiness among contractors about payment problems.

MEED's quarterly Construction Market Index tracks sentiment using five metrics – turnover, backlog/order book, headcount, cash flow and outlook for the coming six months. In the 18 months since the index was launched in January 2016, cash flow has been consistently the worst performer of the five metrics.

Contractors surveyed for this report say that late payments, claims for client variations to contracts not being considered and the adverse trading conditions have brought into question the very survival of many construction firms in the UAE.

These concerns are not surprising. Securing payment is a long-standing issue in the region, where even during good times contract payments can take several months for clients to release to contractors.

The perception of Abu Dhabi as a reliable payer has changed

Abu Dhabi, with its strong financial reserves, has traditionally been considered a dependable market for contractors in terms of payments. That perception has changed over the past two years and the outlook for Abu Dhabi is, if anything, more negative than it is for Dubai, where payment issues have traditionally been more of a problem.

LATE CERTIFICATION ADDS TO THE PRESSURE

Challenges arise once the advance payments are spent and the retention for work completed remain held by the client

Today, 80 per cent of contractors surveyed by MEED say that work is being certified late by the consultant. The majority of late certifications are made within one month of the scheduled date, although nearly 45 per cent of certifications are more than one month late, with some 10 per cent extending to four to six months late.

The delays in certification are traditionally mitigated by advance payments, which give a financial buffer early in the project. The challenge comes once the advance payments are spent and the retention for the work completed held by the client increases. At this point, the project becomes cash-negative. It is also around this point on building jobs that the main contractor completes the direct works and begins engaging more with the subcontractors and suppliers to complete the finishing works.

If specialist suppliers only work if paid up front or given letters of credit, the contractor will need financial support to complete the project.

The contractor's work is certified or validated on site by the project engineer, who is then required to inform the client that certain works have been completed and the contractor should be paid for it.

Direct appointment

Because the engineer is appointed directly by the client, the engineer tends to act in the interests of the client rather than independently, and on many projects, engineers are not permitted by clients to issue certificates unless the client signs off on it. This means the full amount for the work completed may not be certified, and the balance then moves into dispute or claim, which further affects the cash flow of the project.

CONSULTANTS STRUGGLE TO STAY NEUTRAL

While payment delays are not a new phenomenon, the current downturn has made the situation a lot worse

Maintaining neutrality is seen as a challenge for consultants, according to respondents to the MEED/ Mashreq UAE Construction Survey 2017. Consultants typically represent the client and risk losing work if they act against the interests of the client. This issue often comes to the fore if a dispute then moves to court, and the engineer is required to demonstrate that they acted impartially.

Payment issue

Once work on site has been certified, the next issue is the time taken for clients to release payments, and again, like certification, this is late. The majority of late payments are received within six months, with only 6 per cent of respondents saying payments were received within six to 12 months. The majority of respondents receive late payments within two months, with a total of 61 per cent saying they are paid either within one or two months.

These delays are in breach of the obligations set out in the contractor's contract. When working for private sector clients, the feeling is that payments are delayed because real estate sales are not performing as well as they have done in the past and this has put pressure on developers' treasuries. This behaviour is starkly different to contractors' experiences in the past, when payments were released early so projects could be accelerated and delivered more quickly.

For government clients, late payments are typically the result of budgetary constraints as the client is unable to secure additional funds from the relevant finance ministry/department, or the result of bureaucratic stalling, where payments are slowed down as they wait for authorisation.

While payment delays are not a new phenomenon, the current downturn has made the situation worse. Unlike the 2008 downturn, this time it has become more prolonged, which means many of the underlying issues with projects have not been resolved. In 2008, as projects were put on hold or cancelled, contractors stopped work and outstanding payments were limited.

Different market

The market dynamics since 2014 have been starkly different. Instead of crashing, the market has slowed; and instead of projects being put on hold, they have continued. That is not to say that projects are proceeding swiftly without challenges. Most project clients in the UAE are operating with tight budgets and are trying to conserve cash.

Cash is conserved by value engineering projects either before or during construction, or by delaying payments and reducing outgoing to claims. The impetus by project clients to conserve cash means that the payment situation for main contractors has deteriorated and it has continued to worsen over the past year.

Contractors working on private sector real estate projects have been most affected by payment delays

Contractors working on private sector real estate projects have been most affected by payment delays. Companies working for government and semi-government entities are the most likely to be paid on time, while firms working for private sector companies are more likely to be experiencing payment difficulties.

Government clients have a government guarantee and even if the project exceeds its initial budget, it is possible to engage with the client body and resolve the issue as there is always the option of getting approval for more spending from the relevant ministry or department of finance.

With the private sector, this is not always possible, and most contractors surveyed say they have had at least one bad experience where a private sector developer has gone bust, leaving the contractor with little recourse for outstanding payments.

Special purpose vehicles (SPVs) – companies set up to deliver and operate projects – can also be problematic. This is because SPVs tend to be funded with bank debt, and the bank is unlikely to extend that funding any further as the business model has little built-in flexibility. This means if there are variations or overspending on the project, the SPV is unable to meet these costs.

SUBCONTRACTORS PUSH BACK

Hardening market conditions have seen a reversal in the power relations between main contractors and subcontractors

As construction's main contractors seek to manage their cash flows, late payments by clients are often passed down the supply chain as main contractors delay payments to their subcontractors and suppliers, who are typically on back-to-back contracts. That means if the main contractor is paid late, they will be paid late also.

In 2017, subcontractors and suppliers have started to respond to late payments by refusing to work unless paid up front, or given letters of credit from a bank. This means that if main contractors are unable to pay up front and give letters of credit, it can cause progress on some projects to stall, giving clients a reason to say that their main contractor is not performing.

This is a reversal of the traditional scenario, where a main contractor benefits from more favourable payment than available to companies further down the supply chain.

Contractors have also started to prioritise which companies get paid. Traditionally, the most long-standing creditors have been paid first. This has changed as the market has hardened. Main contractors are now prioritising payments to the companies they need in order to complete work, because that is the fastest way to be paid. This means concrete and reinforcement steel suppliers, which are traditionally the first to be paid and are often able to leave a project before any cash problems arise, now face a new predicament as they are forced to wait in line.

Contractors are prioritising which companies get paid

RETAINING RETENTIONS

Delays in the returning of performance bonds is a major issue

Without being able to influence the text of individual retention or performance bonds, the majority of contractors surveyed said that they would welcome the introduction of standardised wording for performance guarantees.

It would help overcome the typically one-sided nature of the bonds they currently agree to, and it would also give them a greater degree of comfort on their projects.

Delays in the return of retention bonds is another growing problem. Some 65 per cent of survey respondents said that they do not receive their retention back on time.

The main reason for these delays is that an increasing number of projects conclude with unresolved claims and disputes. Clients like to keep hold of the retention bond as a bargaining tool that can be traded during those negotiations at the end of the contract.

The vast majority of retention bonds are returned within one year of the due date. More than 50 per cent of contractors surveyed said that their retention bond was returned within six to 12 months, and some 35 per cent within six months.

About 74 per cent of contractors surveyed for this report said that they receive their retention back in full despite clients delaying its return. For the 26 per cent that do not receive retention back in full, the explanation is normally that there has been a dispute on the project and the client has considered it necessary to withhold cash.

The survey respondents said that the text of performance bonds does not help the contractors cause, and the wording is typically one-side in favour of the project client. The majority do try to influence the text to make it more balanced, but they are often unsuccessful and their suggestions are ignored.

For government, semi-government and large private sector clients, the legal team is typically based within the corporate body rather than the project team, and contractors are often not able to speak to the lawyers directly to try to explain why the text should be amended.

CLAIMS PURSUED FASTER

Contractors are now tabling claims while they still have leverage over the client

A further block on payments to contractors is the adoption of a confrontational approach to contractor claims for additional payments for work variations not included in the scope of the original contract.

Variation claims generally are not approved promptly, which means contractors must fund any extra work themselves until the claims payments are approved, or else risk the project being delayed and incur even more costs and penalties.

Time overruns are a problem when contractors have not secured an extension of time. While these are often granted, they are not received until the end of the project. This is because, like retention bonds, it is held to the end of the project and used as a bargaining chip when settling the final account against any cost overruns.

Different market

This approach puts unnecessary stress on a project as it forces the contractors to spend money and resources accelerating work that may not need to be completed so quickly. This diverts money and resources that could be spent on other more worthwhile parts of the project. The inefficiencies created by not granting extensions of time affect cost and quality, and as a result increase the likelihood of disputes and legal proceedings at the end of the project.

The consensus among the majority of construction contractors surveyed for this report is that the challenges experienced over the past year will continue. The issues will not be helped by Dubai's determination to drive ahead with new projects, which will absorb project clients' resources at the expense of existing projects that are approaching completion.

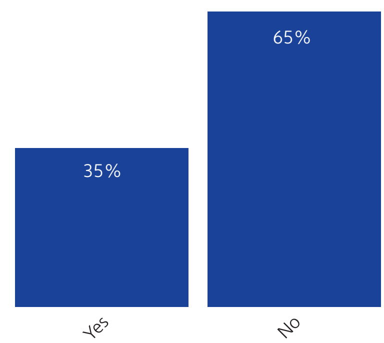
Lessons are being learned.

In the past, contractors have been slow to table claims, which has given clients the upper hand as typically the work has already been completed, and in some cases even handed over. This means there is little consequence for the client if the claims are not entertained.

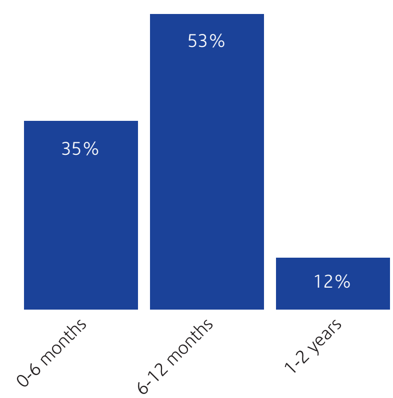
Realising this, contractors are now pursuing claims while they still have leverage over the client, namely before their work is completed and the project is handed over.

UAE CONSTRUCTION SURVEY 2017

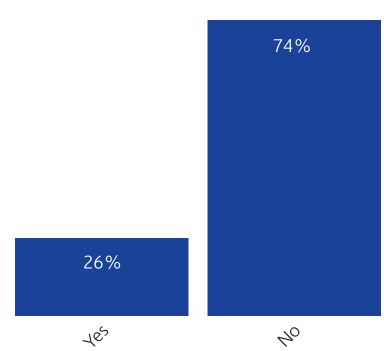
Are your retention bonds returned on time?



If retention return is late, how late is it typically?



Are variations certified progressively and in a timely manner?



THE WAY FORWARD

Many of the chronic challenges facing UAE construction companies could be addressed through changes to forms of contract model

Although the UAE construction market has avoided the severity of the downturn in construction activity experienced elsewhere in the region, there is an overwhelming feeling of frustration coming from construction companies when it comes to payments.

Contractors say that they feel trapped between project clients that are delaying payments for work done and therefore starving them of cash, and a supply chain that is refusing to work unless cash is paid up front. This is hindering the ability of main contractors to deliver projects as planned and is putting them at risk of penalties for not completing work either on time or to the specified quality.

Conserving cash

The main sources of tension are late certification, delays in issuing payments once work is certified, and a confrontational position from clients when it comes to claims.

The issue of late payments once work is certified relates to the availability of liquidity. The problem is most acute in the private sector, where clients, who are mostly real estate developers, have been conserving their cash as much as possible as property sales dwindle. The issue is less severe with government clients, where although budgets have been put under pressure due to lower oil prices, payments are not overly late.

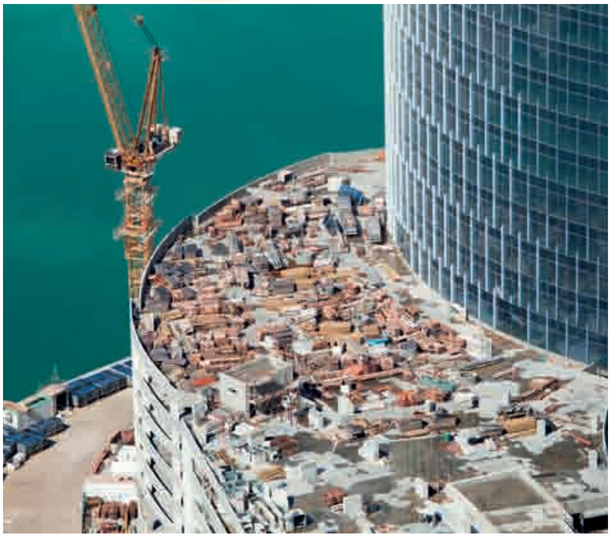
Fast track

Like late payments, late certification and claims disputes have become worse because of liquidity challenges in the market, but they also highlight structural issues within the construction industry that can be exploited if clients choose to delay payments.

Delayed certification and increasing resistance of claims bring into question the neutrality of a project engineer. This is a long-standing issue that is not unique to the UAE or the Middle East.

The problem is amplified in the UAE by the fact that many projects in the region are fast-tracked and proceed to the construction stage before designs are fully complete.

This means contractors frequently take on projects that change in scope during the construction period, resulting in claims that clients do not think they should have to pay because they feel the ultimate design is what they always wanted in the first place, and therefore there are no design variations.



Late certification and claims disputes have worsened due to liquidity challenges

The claims issue is particularly difficult to resolve with private sector clients. Many private sector projects are funded with debt and often this is raised using special purpose vehicles (SPV) that frequently encounter difficulties when securing additional financing from the banks above the original contract value.

New models

One possible solution to the volume of claims and the subsequent dispute would be to use different forms of project delivery such as design and build, where the contractor is responsible for the design, or alternative procurement methods such as two-stage tendering, where contractors are brought in early to help develop the design and avoid many of the unknowns, and potential claims, that may occur later, before the actual construction contract is signed.

The region has been slow to adopt these alternative delivery methods. Although there have been examples where they have been used, both government and private project clients in the UAE tend to prefer using fixed-price, lump-sum contracts that are competitively tendered and awarded to the lowest bidder.

It is unlikely that this attitude will change without a degree of deliberate intervention. In other jurisdictions, governments and government agencies have spearheaded the adoption of alternative procurement methods, and with payment problems expected to worsen and the number of disputes rising, now may be the time for such a policy intervention in the UAE.

Arranging finance

One way that contractors have been able to mitigate this problem is by helping to arrange funding for projects. Over the past five years, there has been a growing trend of international construction companies assisting with arranging financing for their clients.

UK firms have been market leaders in this area and have been able to secure work on several projects in Dubai and Abu Dhabi with export credit guarantees from UK Export Credit. These guarantees mean that the funding from banks is underwritten by the UK government, and crucially from the contractor's point of view, when work is completed and certified, the funding bank will release payments.

There are also signs that the way government and government-related entities procure construction services is starting to change.

Earlier this year, Dubai-based contractor Alec was acquired by the Investment Corporation of Dubai (ICD) from Abu Dhabi's Al-Jaber Group. The move helps Dubai secure contracting resources for key projects. Alec has been the prime contractor on the expansion of Dubai International airport since 2008, and the change in ownership will result in relationships such as the one at the airport becoming more common.

In June, ICD awarded Alec the contract to build its One Zabeel tower project in the World Trade Centre.

South Korean contractor Ssangyong, which was acquired by ICD in 2015, has secured work on landmark projects in Dubai such as the Royal Atlantis Resort & Residences on the Palm Jumeirah expansion and ICD Brookfield Place at DIFC.

Abu Dhabi also has controlling stakes in construction companies. Aabar controls more than 37 per cent of the shares in Dubai-listed construction company Arabtec Holding and since it took control of the company Arabtec has secured work on several landmark projects in Abu Dhabi, such as the Midfield terminal building at Abu Dhabi International airport.

As paymaster and shareholder of these construction companies, it is in the government's interest to ensure payments are made on time and claims are entertained fairly. If the trend continues and more contracting companies are acquired then the supply chain in general should benefit from more prompt injections of cash.

PPP HOPES

The development of PPP projects in the UAE could reduce the problem of late payments

Radical changes could be introduced through innovations in the way projects are funded.

Since late 2014, the UAE has begun to re-explore the use of public-private partnerships (PPPs) to deliver government projects. Using the private sector to deliver projects in partnership with the government takes away the initial capital expense required from the government, while also bringing in construction and operational expertise from a private sector consortium.

The schemes typically involve a private sector consortium delivering a project and operating it for a period of time, during which it will derive revenues from the service it provides that compensate for the expense of building it.

Large projects

PPP projects often include contracting firms as consortium members responsible for the delivery of the construction work. This is not only an investment opportunity for contractors, but also a way to deliver large-scale construction projects without being so reliant on clients for payments.

The UAE and the rest of the region has been exploring the use of PPPs for the delivery of projects since late 2014

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Today, Mashreq has a significant presence in 11 countries outside the UAE, with 21 overseas branches and offices across Europe, the US, Asia and Africa.

Mashreq launched its new Vision and Mission recently, outlining its commitment towards its clients, colleagues and the community. In line with its vision to be the region's most progressive bank, Mashreq leverages its leadership position in the banking industry to enable innovative possibilities and solutions for its customers across corporate, retail, international, treasury and Islamic banking.

Mashreq is proud to be the first financial institution in the UAE to be awarded the Gallup Great Workplace Award for four consecutive years from 2014-17. Mashreq also continues to invest in recruiting, training and developing future generations of UAE national bankers.

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