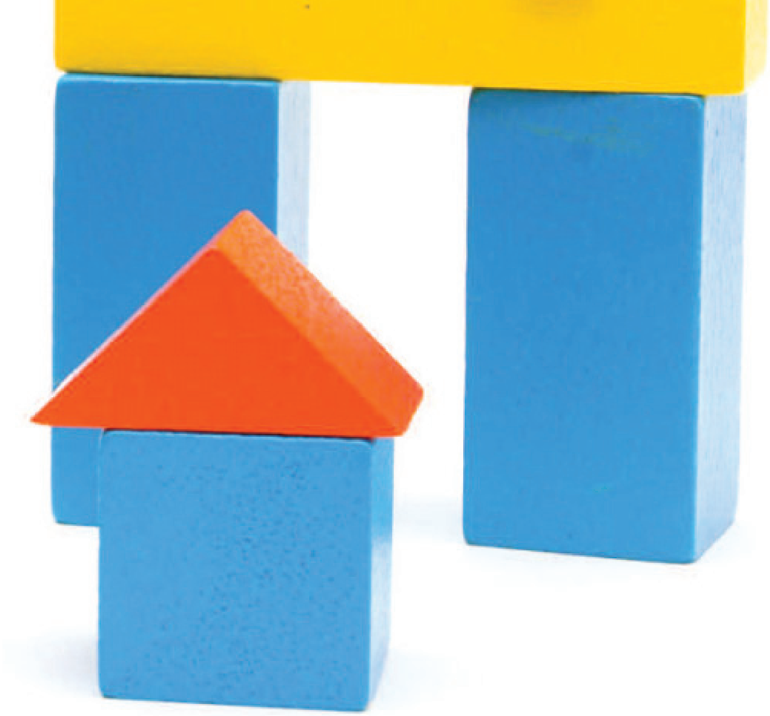
Back to Basics:

Reconstructing Risk Management



From skyrocketing prices of construction materials and labor to the suspension, or outright cancelation of projects due to lack of financing, construction companies in the Gulf, particularly in Dubai, have navigated their fair share of turbulent waters. One thing they can learn from their experiences is the importance of prudent risk management. This article focuses on only a few, albeit critical, elements of a complete risk management plan.

Lesson 1: Know Your Customer

Many financial institutions and contractors in the Gulf region have been guilty of entering into contractual agreements based on the customer's name and reputation alone, without consideration of the basic fundamental risk management philosophies: looking into the financial viability of the project and the collateral associated with that customer.

This lapse may lead to significant construction and/or financial problems and risks as the project progresses. These problems range from changes in the scope or design of the project to problems of receivables collection, via claims issues - all financially costly and time-consuming for the contractor.

It is therefore crucial to understand the customer, their needs, their technical understanding of the project lifecycle, the viability of the actual project and their financial resources for the project. These are all basic, albeit lengthy, requirements that contractors should address. But faced with double digit yield margins, contractors in the region sometimes chose expediency over diligence, with dire consequences.

Lesson 2: Negotiate Performance Bonds

Performance bonds are typically issued in favor of the project owner for the full duration of the contract. Normally, a margin would be held by the issuing bank as collateral against the bond, with the size of this margin depending on the relationship between the contractor and the bank. These performance bonds are not released until the project is completed and free from defects.

Such practices incur additional costs for the contractor and put pressure on their cash flows if the margins held by the bank are significant. The performance bond can also tie up financing facilities when the release of the bond is unnecessarily delayed at the completion of the project.

While performance bond specifics could be negotiated at the commencement of the contract, traditionally "on demand" bonds for the period of the contract is the standard industry practice in the region.

In western markets, for example, the level of performance bond usually decreases as the project develops. Certain milestones in the construction cycle may trigger both the release of margins held and the share of performance bond required for the remaining life of the project, thus reducing the burden on the contractor. This is eminently sensible and manages the risks from both, the contractor and the employer's perspective.

If the contracting industry in the Gulf wants to change this accepted practice, contractors will need to stand together to drive this change and reduce the risks that they get exposed to.

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Lesson 3: Manage Cash Flow

If the recent credit crisis has taught us anything, it is that cash flow management in any business is crucial. For contractors, accurately forecasting costs to completion, the timing of these costs, and receiving timely progress payments (net of retentions and any advance payments) is critical to their success for healthy cash flow management.

Policies and procedures regarding charges on overdue receivables and the contractor's ability to suspend work on unpaid contracts are becoming more commonplace as contractors have been forced to face the brunt of project funding instead of the developers. Contractors need to be stricter in implementing their rights under the International Federation of Consulting Engineers (FIDIC) to suspend work where payments are not forthcoming and should implement tighter controls around project cash flows. It is obviously important that this is done professionally and with the appropriate balanced sensitivity to their employer relationships.

Lesson 4: Keep Proper Documentation

To date, construction work in the UAE has been characterized by fast-track construction – beginning construction with incomplete designs, which are then completed as the project advances. As a result, variation orders and claims are common, although the process to resolve them is often slow and drawn-out. In a market where variations can sometimes form 40% or more of the final contract value, contractors are burdened with cash flow constraints and financing costs for these variations and claims until a final agreement is reached, with significant consequences on their financial reporting periods given the uncertainty they face until the final settlements are agreed.

For the majority of contractors, portions of the cost management tracking systems and documentation requirements of the project have, for numerous reasons, been neglected or under-resourced until actually needed, when the information is hastily pulled together retroactively.

Such documentation is key to identifying variations and claims, measuring the extent of the variation/claim, and providing evidence of the issue to the contract owner. The quality of the information available from the contractor can significantly aid in the prevention of a dispute, by providing timely and well-documented information about the issue for the stakeholders to consider. Where a dispute is inevitable, such information captures accurate details that can be easily supported with evidence to enable a speedy resolution.

Given the magnitude of contract variations noted, by not addressing this issue in any robust risk management plan, a contractor is inevitably delaying settlement/payment of variations/claims through not being able to demonstrate clearly how the issue arose and its full scope. Retroactively producing the information provides the basis for challenges against the authenticity of the claim due to the potential lack of valid information, and unduly delays resolution. Contractors need to better manage this process and change the standard practice to one where the value of the variation is certified as they progress, rather than leaving it until the end of the contract.

This necessary change in practice will ensure that contractors get paid for the costs they incur and that the contract owners appreciate the costs of the changes they request, which can often be fundamental (and costly) design changes.

Lesson 5: Learn the Lesson

As many Dubai-based contractors look to new markets as a result of the Dubai property slump, the above lessons become even more important to learn. Expanding into new jurisdictions offers many opportunities to the contractor but also potentially increases their risk as project owners or developers are
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][more likely to be unknown to them.

A proper understanding of the customer's financial stability and the project viability is critical before jumping onboard with the contract. Similarly, a thorough understanding of local laws, regulations and 'normal' business practices is also advantageous, and has led to many contractors seeking some form of partnership with an established provider in the new target market.

Back to Basics

The inherent risks faced by construction firms in the Gulf region over the past 3-4 years demonstrate how important a risk management plan is to a contractor. In the current economic environment, it is important to get back to the basics of risk management, by focusing on understanding the project owner's requirements and resources, cost management tracking systems and cash flow management and thereby focusing on the fine balance between risk and reward.

Here's to implementing the valuable lessons learnt.

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