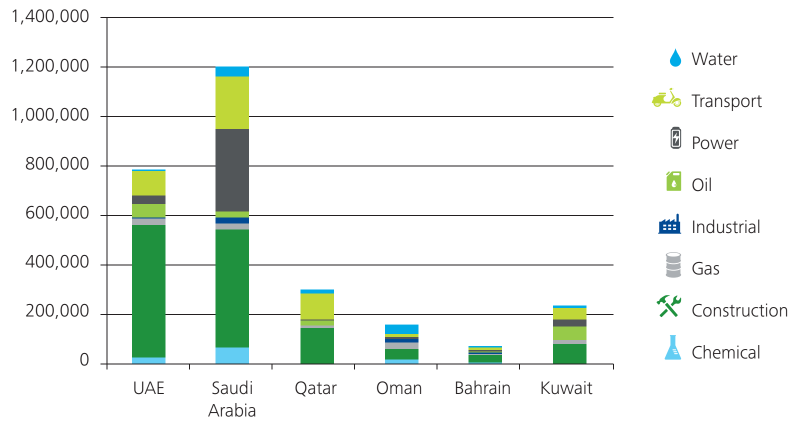
The beat goes on

Despite lower oil prices, the forecast for construction projects awarded in the Gulf Cooperation Council (GCC) countries in 2015 is the highest on record. With construction generally considered as an economic barometer for the GCC, what does this tell us about the economic backdrop in the region?

According to *MEED Projects* magazine, the forecast for projects they expect to be awarded in the GCC in 2015 is US$172 billion, the highest on record. Total projects planned and underway for the GCC amount to US$2.8 trillion, with the majority of the spend being on residential, mixed-use, leisure and hospitality projects amounting to US$1.1 billion.

GCC projects planned and underway (2015) – US$2.8 trillion



Source: *MEED Projects*

Given the heavy dependence of the GCC construction industry on energy revenues, the most significant event of 2014 for the industry has been the sharp plunge in oil prices, which have declined by about 50 percent since June 2014

This is all against a backdrop of lower oil prices, continuing political unrest and reduced International Monetary Fund (IMF) growth forecasts across the GCC. It is also impacted by the deepening recession in Russia and, as reflected in the IMF World Economic Outlook update in February 2015, the projection for global growth in 2015 has been lowered to 3.5 percent, only a small increase from 2014. As per the IMF, the GCC export oil earnings are expected to decline by US$300 billion from the original estimate in October 2014.

Understanding the recent macroeconomic changes in the regional context

Given the heavy dependence of the GCC construction industry on energy revenues, the most significant event of 2014 for the industry has been the sharp plunge in oil prices, which have declined by about 50 percent since June 2014.

As a result of this new price environment, all GCC countries, with the exception of Kuwait, will run fiscal deficits in 2015. In the short-term, it is not perceived to be a pressing concern due to available financing and low debt levels, however, if oil prices remain subdued for an extended period, this will place a growing strain on public finances and may adversely impact their capital and social spending levels. Most oil exporters need oil prices to be considerably above the US$62/bbl projected for 2015 to cover government spending, which has increased in recent years in response to rising social pressures and infrastructure development goals.

Most oil-exporting countries in the GCC have significant fiscal buffers, which allow them to avoid sudden cuts in spending in response to declining oil revenues, nevertheless, most GCC countries are now expected to slow spending growth in the Industrial and Oil & Gas sectors in 2015 compared to what was projected in 2014. So far US$18 billion in this sector has been put on hold, while other projects planned and underway amount to US$2.8 trillion. Oil price and economic volatility could make Government commitment for reforms towards diversification and infrastructure projects more urgent and, possibly, politically easier to implement.

Government spend on infrastructure and capital projects is expected to continue in order to achieve their strategies for diversification, and is expected to drive the demand and growth of the building construction material industries in the GCC region. Preparations for big events are expected to generate healthy project activity across the GCC that will act as a catalyst for the other planned mixed use and infrastructure projects, not to mention the significant focus on development of downstream industries that will further aid the growth of the building construction materials industry.

Markets overview: opportunities and challenges

Saudi Arabia is strongly focused on diversifying the economy to reduce its oil dependence, implying the development of non-oil sectors, and construction plays a major role here. Demographics are a key factor driving diversification: with an estimated 50 percent of its population under the age of 25 and its high growth forecast, job creation becomes a priority, as well as the provision of expanded social services to citizens. Major economic cities planned across the Kingdom are part of this objective. The new cities are expected to contribute US$150 billion to the country's GDP by 2020 and provide job opportunities for 1.3 million people. King Abdullah Economic City (KAEC) is the largest construction project budgeted at US$93 billion. Major transportation infrastructure projects are underway or planned, including the Riyadh metro for US$22 billion or the King Abdulaziz International Airport expansion. With a large number of projects under construction in Saudi Arabia, it is forecast that built asset performance will grow by 70 percent over the next decade, the second highest growth rate behind China. But for Saudi Arabia to achieve this, it will need to deliver a high quality built environment. That need is driving the adoption of international quality standards and best global practice.

There is plenty of optimism in Dubai and Abu Dhabi given the large number of projects in the pipeline, the expected project awards for Expo 2020 and Al Maktoum International Airport and Abu Dhabi's ongoing 2030 Vision with projects currently under construction such as Abu Dhabi Midfield Terminal, Reem Island, Etihad Rail and Yas Mall.

> In the short-term, it is not perceived to be a pressing concern due to available financing and low debt levels, however, if oil prices remain subdued for an extended period, this will place a growing strain on public finances and may adversely impact their capital and social spending levels

Governments are likely to continue spending on social infrastructure projects, with a continued focus on targeting increased tourism and business demands, thus focusing on significant tourism and leisure infrastructure projects.

Factors such as rising labor and material costs, and slow payments seem to impact contractor's profitability and future expectations. There is appreciation for the need to focus on traditional problems including cash flow cycle, time delivery for projects and delivering within the budget, and access to qualified workforce.

Qatar progresses with Qatar National Vision 2030 and the 2022 World Cup. The government has been investing heavily to upgrade infrastructure, including a well-integrated road and rail network, and the new Hamad International Airport to facilitate the forecast growth of tourists. Hospitality is likely to see significant growth in the coming five years driven by the upcoming event, though this should be aligned with enhancing the leisure side creating future leisure attractions, to avoid the risk of hotel rooms oversupply after the event. Social infrastructure such as healthcare and education has also found significant allocation in the country's budget, to ensure diversification and growth towards a knowledge base economy.

To further understand the state of the industry as we face it today, below are the viewpoints of a number of key decision-makers:

China State Construction Engineering Corporation Middle East is the regional operation of the world's largest construction company and top home builder, that started its Middle East market entry with the iconic Palm Jumeirah Villa Project over ten years ago. We spoke to Mr. Yu Tao, President and CEO of China State Construction Engineering Corp Middle East. We asked Mr. Tao about the current market and opportunities and he noted that there are visible signs that the building market is really coming back, with more tender inquiries, specifically for hotel projects, in accordance with the Dubai government's plan to attract more transit visitors. On the other hand, he observed that the infrastructure market is taking longer to recover. However, Mr. Tao said he sees great potential around support related to Dubai Expo 2020 and the increasing population putting more demand on infrastructure needs.

Oil price and economic volatility could make Government commitment for reforms towards diversification and infrastructure projects more urgent and, possibly, politically easier to implement

Commenting on the funding issue, Mr. Tao highlighted that: "We expect funding to be the ongoing challenge when you look at the extent of infrastructure projects planned and underway, that is why we have developed a unique proposition for our clients, which is to offer project funding or export credit opportunities." When commenting on cost controls, he said they expect that managing costs effectively throughout the work process will remain a priority as the tender process is very competitive having and impact on the tender margins. Mr. Tao added that he expects ongoing challenges regarding design variations and managing variations to remain a feature of the construction industry, particularly because of the complexity of projects and timescales in which designs are done and executed, and said they have strong processes to track and manage change orders to ensure they recover all additional value for additional work done.

Mr. Tao further acknowledged that the clients of today are much more cost-conscious and put a lot of pressure to manage the budget efficiently, and noted that profit margins across the industry are very low. Even globally, contractors have been struggling to meet a two-percent margin, while carrying the burden of funding a 10-percent retention, making the sector highly risky. He felt that the industry has to find a way to create an environment conducive to the healthy development of the market that takes contractors' concerns into consideration.

Qatar Society of Engineers is a non-profit professional organization formed by approximately 200 Qatari engineers. We spoke to Mr. Ahmad Jassim Al Jolo, Chairman of the Board who shared with us his thoughts on the Qatari construction market. The local construction sector, he said, faces the challenge of non-robust building codes, leading to uniformity and inconsistency due to consultants bringing to the market their own standards. The Ministry of the Environment (MOE) is working on producing a solid Building Code to achieve standardization. Another challenge that needs to be resolved is high construction costs–Qatar is the most expensive GCC country for construction–which is mainly caused by the cost of materials. Qatar being a small country relative to its planned expenditure, needs to import its material and labor and is constrained from a logistics point of view. Doha's old port capacity is often considered as a source of increasing costs, causing bottlenecks and delays on projects delivery time. Not to mention the ambitious infrastructure programs of neighboring countries in the region leading to competition for materials and qualified employment workforce.

In summary, there are several key factors driving the planned capital projects included in the US$2.8 trillion planned and underway. These will need to be carefully planned and controlled so as not to exceed budgets and appropriately structured to achieve the necessary debt and capital funding. The whole life cost of these assets should be assessed to ensure they have the intended economic impact, they deliver value for money and that the day-to-day operation and maintenance costs are reduced to sustainable levels.

by **Cynthia Corby**, Partner, Construction industry leader, Deloitte Middle East

Governments are likely to continue spending on social infrastructure projects, with a continued focus on targeting increased tourism and business demands, thus focusing on significant tourism and leisure infrastructure projects