Construction 2017: A positive market outlook?

According to the International Monetary Fund (IMF), GDP growth across the Gulf Cooperation Council (GCC) is expected to have reached 1.9 percent by the end of December 2016. In 2017, it is forecast to increase to 2.3 percent. This growth is a reflection of a stabile oil price and increased market confidence, underpinned by strategic initiatives aimed at reducing oil dependency, such as Vision 2030 in Saudi Arabia.

The current oil price rebound has resulted in the price per barrel reaching anywhere between US$55-60, which is a marked improvement on previous lows of mid-high US$20 per barrel. That said, oil prices hovered around US$100 per barrel for a prolonged period of time until mid-2015, and it is therefore not unreasonable for oil-generating economies to tighten their belts against a backdrop of falling revenues.

This has meant that governments have been reviewing their budgets more closely and prioritizing expenditure on strategically important projects, rather than speculative or vanity projects. A decline in project awards has impacted the construction industry first and most profoundly. The markets most affected are Saudi Arabia, Qatar and Abu Dhabi, while Dubai, Oman and Bahrain have been less affected due to a greater level of economic diversification.

Impact on the construction industry is significant

The reducing volume of project awards has been a major issue affecting the construction industry, but it is not the only one. Due to the lower number of projects and tightened budgets generally, there is an increased level of competition across the industry to secure those few contracts that are still being awarded, and this has translated into downward pricing pressure, i.e. reduced margins when preparing project budgets or estimates.

The lower volume of project awards has not necessarily translated into quicker decision-making either. In fact, it has also affected the decision-making process because ever more scrutiny is being placed on award decisions, and this in turn is affecting the contracting industry that is reliant on a steady pipeline of projects just to remain solvent.

Moreover, the tightening of budgets has unfortunately manifested in a number of government entities delaying, or in some cases, deferring payments and this has constrained cash flow across the entire industry–in some cases resulting in significant financial issues and social unrest. The 2015 Deloitte *Powers of Construction Report* included interviews with C-Suite personnel across the contracting industry, and the feedback provides compelling reading. In particular, it was noted that the average collection cycle, from completing the work to collecting the cash, totaled 225 days and there have been no reported improvements in the cycle since then. Indeed, the simple act of processing invoices has become ever more protracted and adversarial with innumerable examples of "the engineer either not certifying interim payment certificates (PCs) or substantially reducing the certified amounts for very minor technicalities or differences of opinion." In other well reported cases, government agencies have issued promissory notes in lieu of physical payments as they simply do not have the funds to honor those payments. Often the promissory notes are then later converted into a reduced

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cash payment, which then exacerbates the same cash flow issues being experienced by the contractors and their supply chain.

In a similar vein, pricing strategies are becoming more divergent. Given the prevailing market conditions, many contractors will look to reduce margin and accept work to maintain turnover, but will do so without necessarily considering or pricing-in risks lest they become commercially uncompetitive. In a more buoyant market, contractor pricing converges, where many bidders will consider both risks and opportunities and factor this into their commercial offer–which benefits all parties because risks are known and foreseeable, and opportunities are considered proactively.

Linked to this trend of low margin pricing is the increasingly common occurrence of contractors looking to enhance revenue through variations. According to the *Deloitte Powers of Construction 2015* C-Suite survey, 73 percent of the respondents confirmed that their bidding strategies were predicated on making money from variations, either client-driven changes, to the scope or technically derived changes due to constructability or design issues. This in turn can lead to conflict during the delivery of projects and often manifests in contractual claims for time and cost, as has become increasingly apparent during this latest economic cycle.

What does the future hold for construction across the GCC?

There are certainly positive macro-economic drivers for construction that include population growth, diversified economic growth, a growing younger labor force, and localized drivers such as Vision 2030 and Expo 2020, in addition to a strong tourism drive for a number of governments across the region. The recent OPEC (Organization for Oil Producing Countries) agreement to cut oil production appears to have further stabilized prices, at least in the short term.

According to *MEED Projects*, the total value of projects either in the planning stage or in the delivery stage across the GCC is US$2.7Tn, with Saudi Arabia leading the way with US$1.1Tn of projects, followed by the United Arab Emirates with US$830Bn and the remaining total spread across Kuwait, Bahrain, Qatar and Oman. Clearly, a pipeline of projects of this magnitude has to be perceived in a positive light by the construction industry–the key question is when these projects will reach the contract award stage, as only then will the positive economic impact be truly felt.

Conclusion

While the economic headwinds prevail in the short term, there are signs that these will dissipate over the coming months and that 2017 will represent an improvement over 2016. The sheer volume of projects either being planned, or currently being executed, in addition to the wider strategic initiatives being set in motion by governments across the region, has to give cause for optimism. Such factors, it is hoped, will then manifest into widespread positive sentiment which will result in governments re-engaging in major project expenditure, and contractors (and their supply chain) taking more confidence in this and pricing more conventionally.

With more focus on capex efficiency, return on investment and much more targeted investment strategies, clients will similarly feel the need to manage risk and balance this against the potential rewards, thereby creating a more focused yet positive contracting environment moving forwards.

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