2019 Contractors Risk profile in 2019

Chris Hunter – Managing Director
NZ Strong Construction

About NZ Strong

- NZ Owned
- 4 Directors, each with over 20 years working for the largest NZ & Australian construction companies prior to setting up NZ Strong
- Tier 1 capability with a tier 2 flexibility and cost structure
- NZ Strong commenced in 2004 and Auckland focused
- Built a reputation for complex commercial & infrastructural projects

About NZ Strong

- Completed over $1.3 billion of projects
- Target projects $15 - $80m, larger projects on their merits
- Focused on counter cyclical clients
- 72 high end project management staff and subcontract out trades
- 8 teams only – not turnover focused
- Utilise the latest technology, i.e. CAD/BIM modelling
- Target sectors – Airports, Local Govt, Central Govt, Aged Care, Infrastructure, NZX Listed Property Companies

"No private developers"

Our Clients

ORAMS MARINE VILLAGE

AT

AIRWAYS
making your world possible

MINISTRY OF SOCIAL DEVELOPMENT
TE MANATŪ WHAKAHIATO ORA

New Zealand Government
Te Kāwanatanga o Aotearoa

ArvidaGroup

Regional Facilities Auckland
An Auckland Council Organisation

AIR NEW ZEALAND

Argosy

Auckland ZOO

Mangere COMMUNITY HEALTH Trust

Fonterra
Dairy for life

vodafone

AUCKLAND DISTRICT HEALTH BOARD
Te Toka Tumai

Precinct
PROPERTIES NEW ZEALAND

Kiwi Property

Westfield

LUNA ROSSA
PIRELLI
PRADA

Infratil

Auckland Airport

MINISTRY OF EDUCATION
Te Tāhuhu o te Mātauranga

Metlifecare

St John

EST 1947
DELEGAT

MOTAT

Housing New Zealand
Housing New Zealand Corporation

Leadership Training

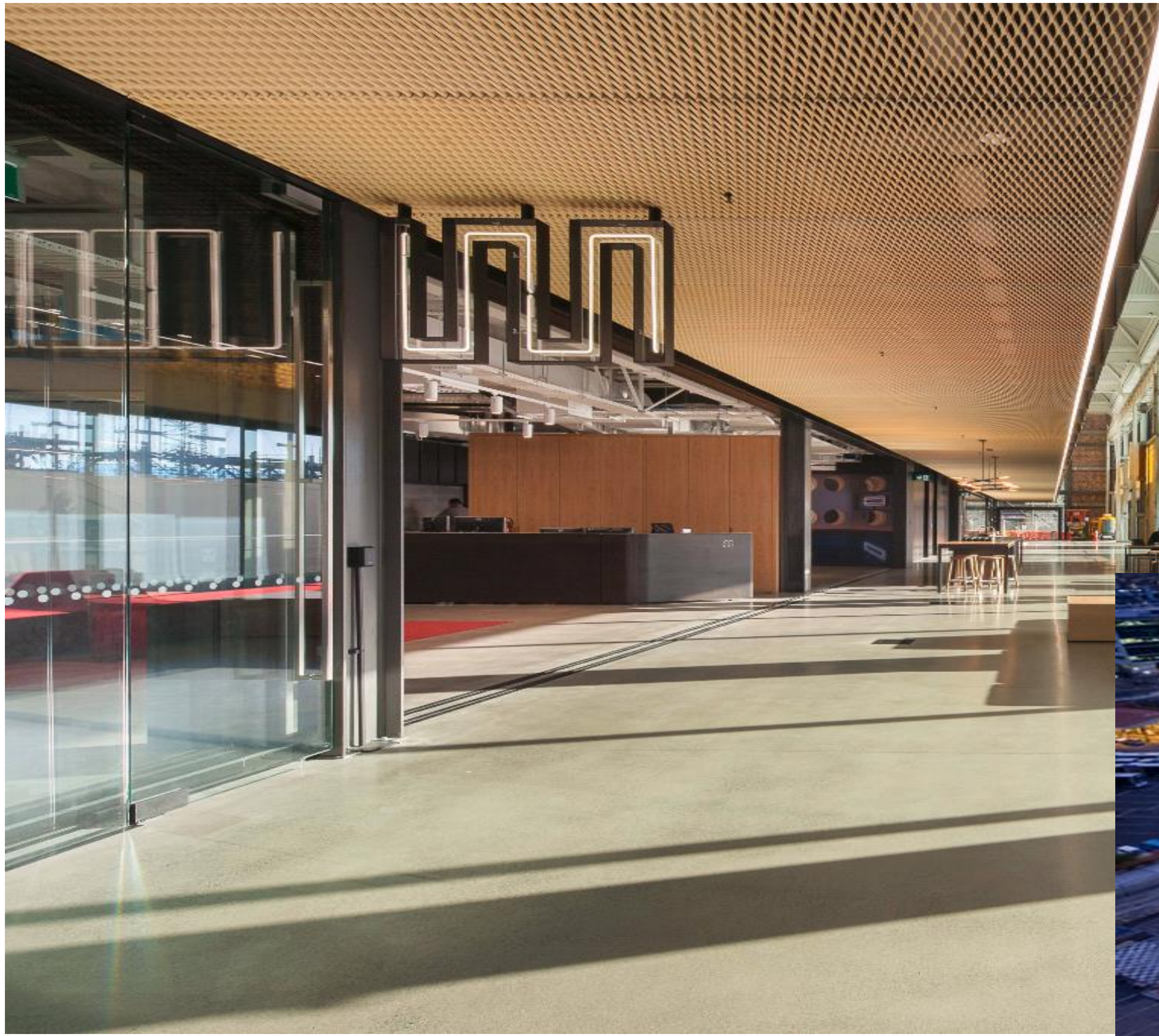
Our vision is to be the most Trusted & Respected construction company in NZ

“better everyday”

Sir Graham Henry – “I provide people leadership training to NZ Strong”

Lynn Mall – Kiwi Property

Mason Office building – Precinct Properties



New Lynn Railway Station

Ameti Railway Station

Northern Busway

Manuakau Station

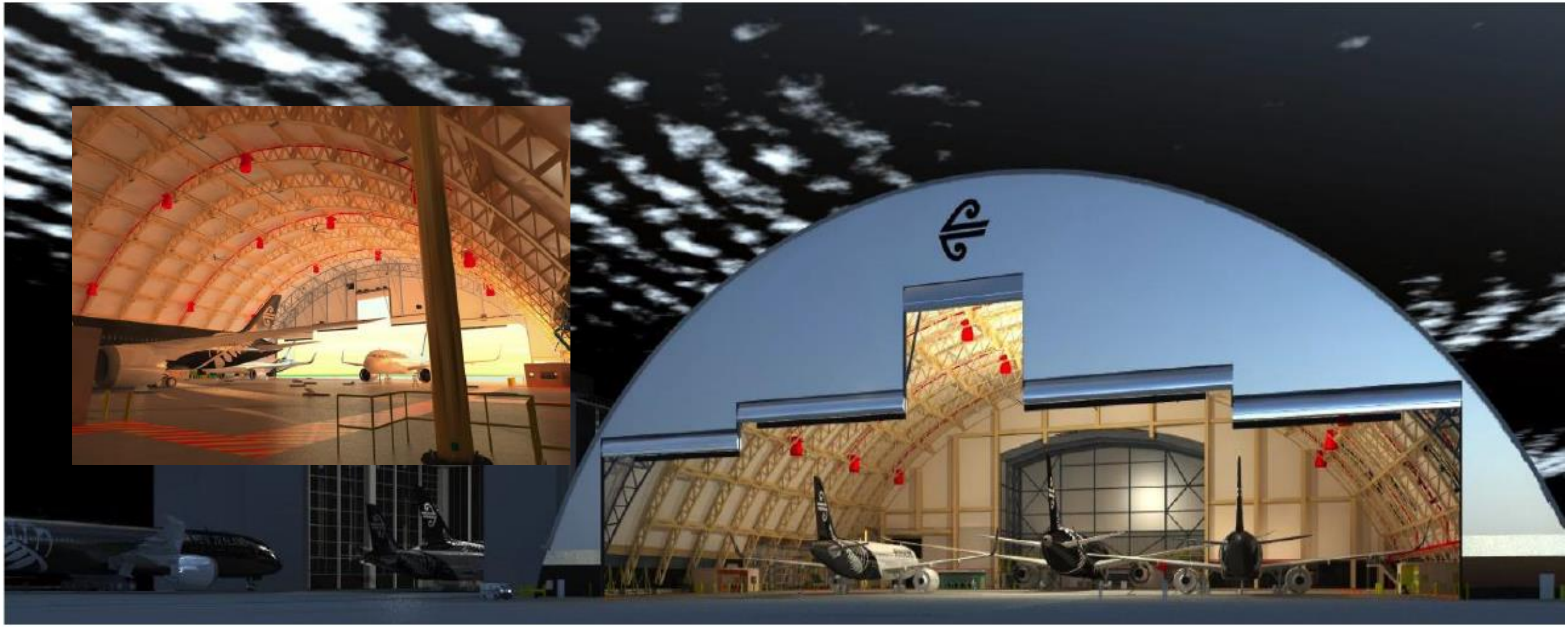
Otahuhu Recreation Pool & Library Complex

Delegat Winery

Aged Care – Metlifecare & Arvida

AIR NEW ZEALAND

AIRNZ HANGAR

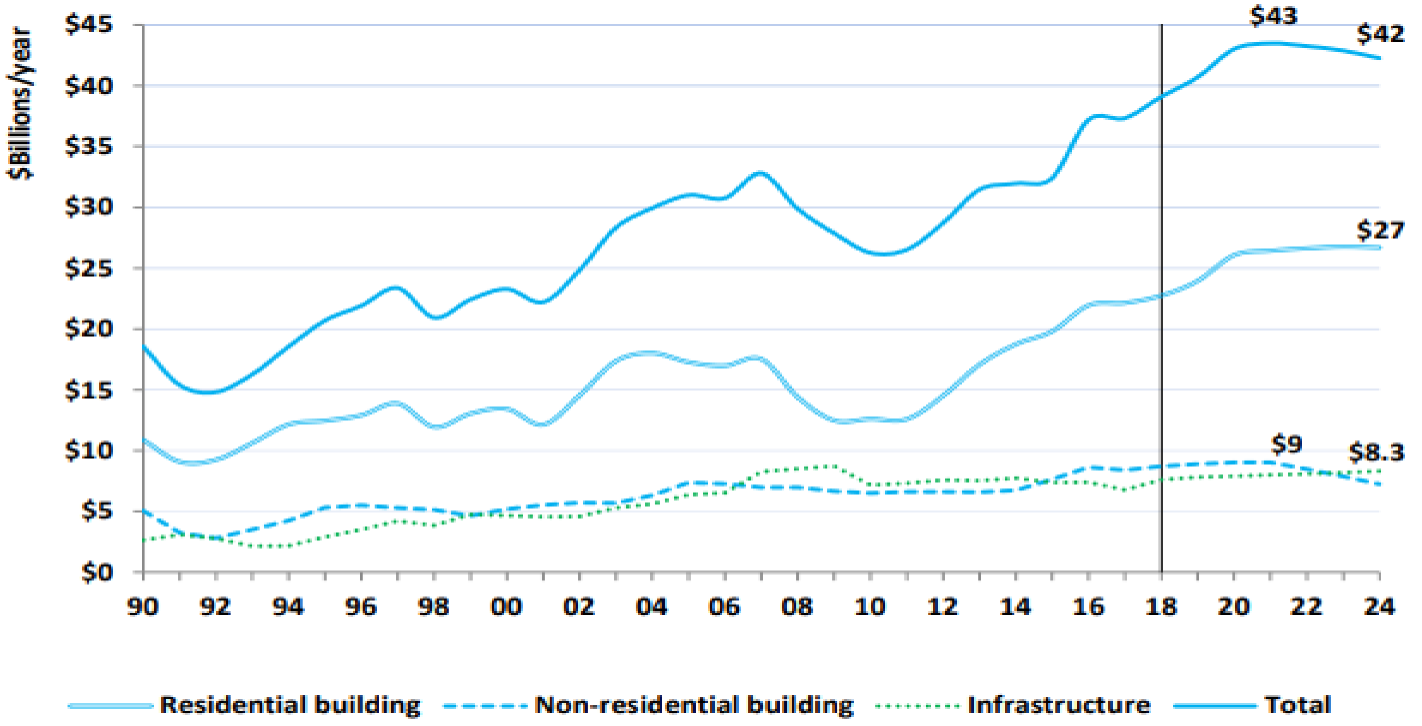


Orams Marine

Yellow Treehouse

Total National Construction Values

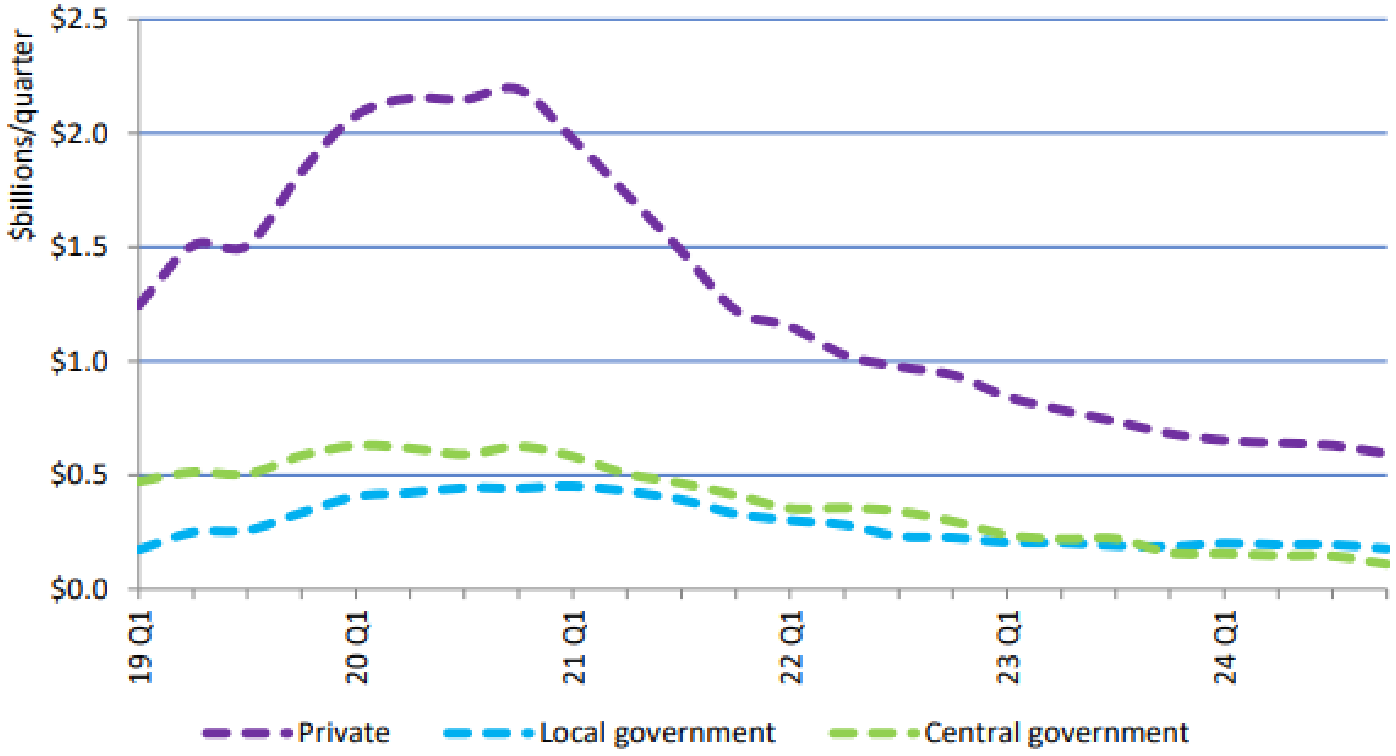
Figure 2.1.1 All building and construction nationally, by value



Source: BRANZ/Pacifecon/Stats NZ

Total National Non Residential by Purchaser

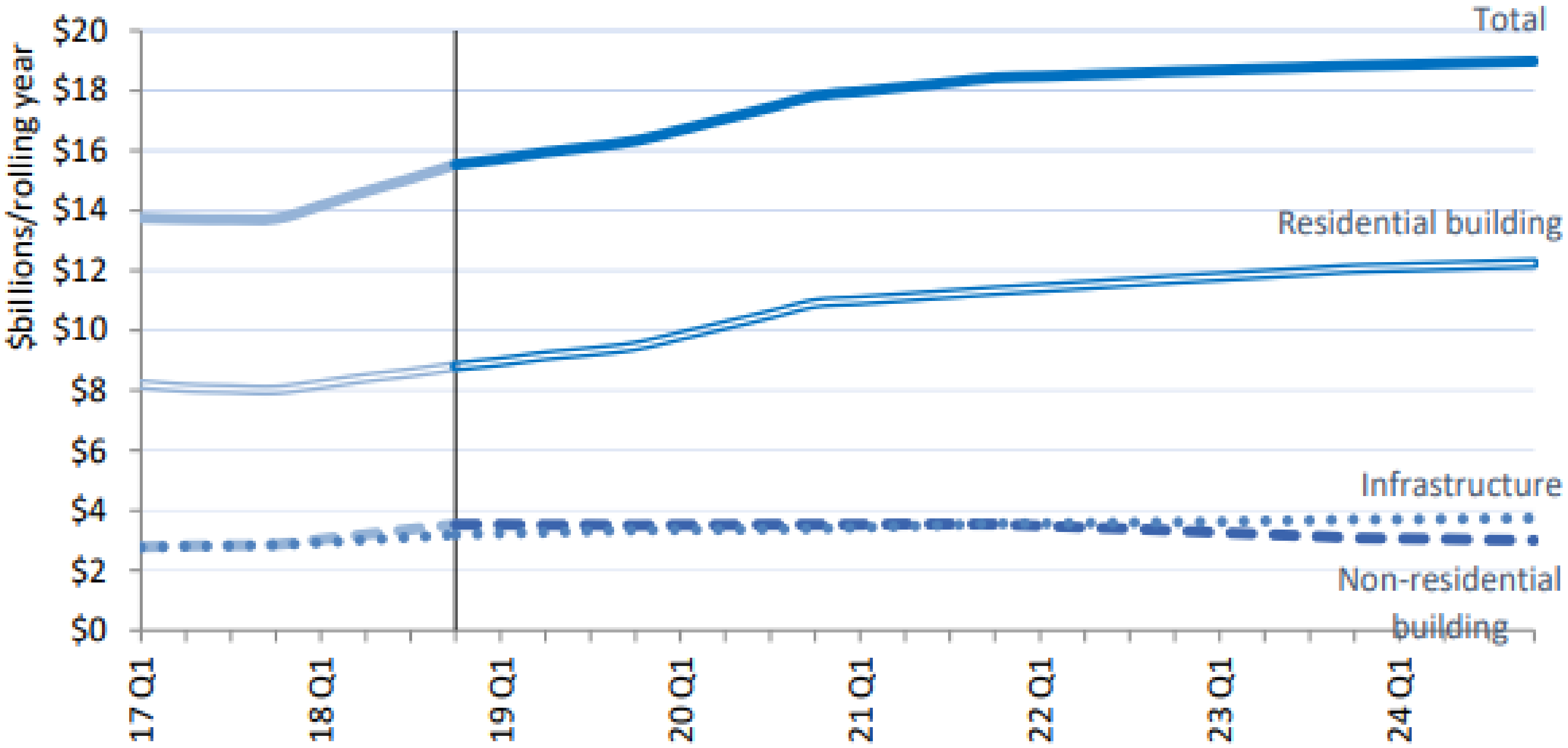
Figure 3.7.1 Non-residential building intentions, by sector initiator and start date



Source: Pacifecon

Total Auckland Construction Values

Figure 4.1.1 All construction in Auckland, by value



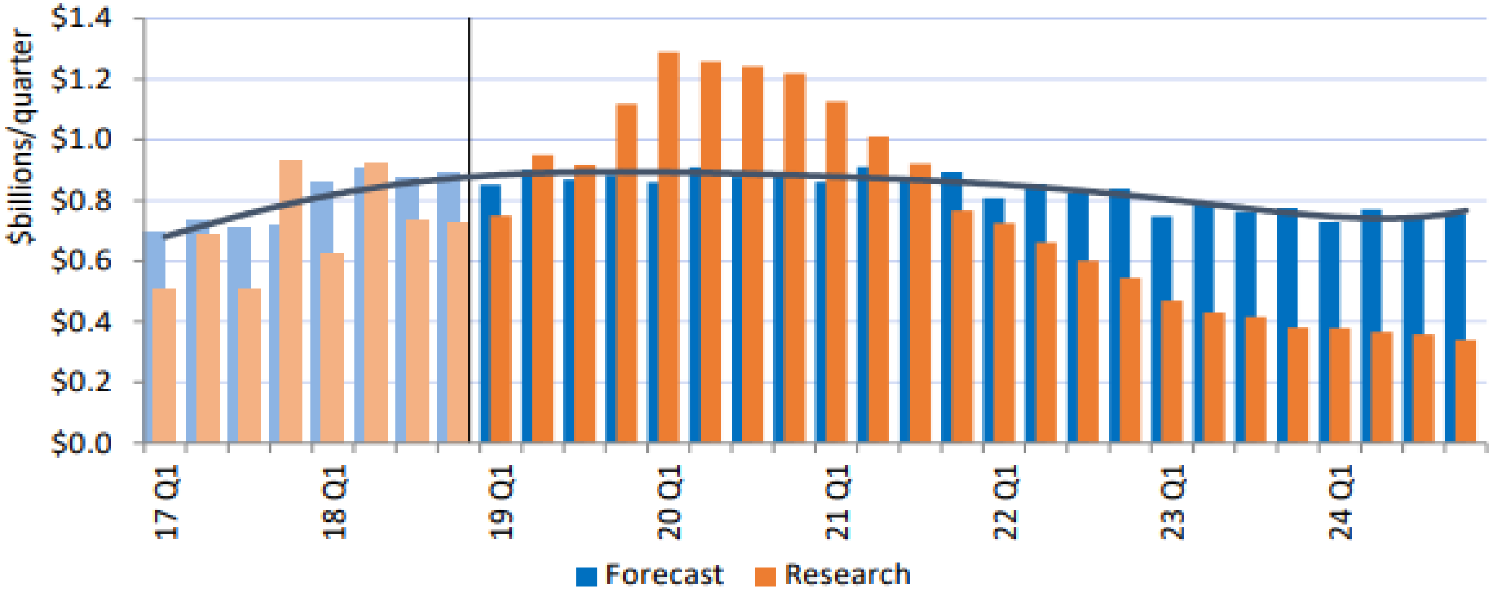
Source: BRANZ/Pacifecon

Auckland Non Residential by Purchaser

Auckland non-residential building activity

Non-residential building activity in Auckland grew by 23% in 2018 and is forecast to remain at this high level and peak at *$3.5b* in 2021. This coincides with a peak in research values over the next two years that indicate strong non-residential building intentions for the region. Non-residential building is then expected to reduce by 15% to the end of the forecast period.

Figure 4.1.4 Auckland non-residential building activity



Source: BRANZ/Pacifecon

Auckland Non Residential by Purchaser

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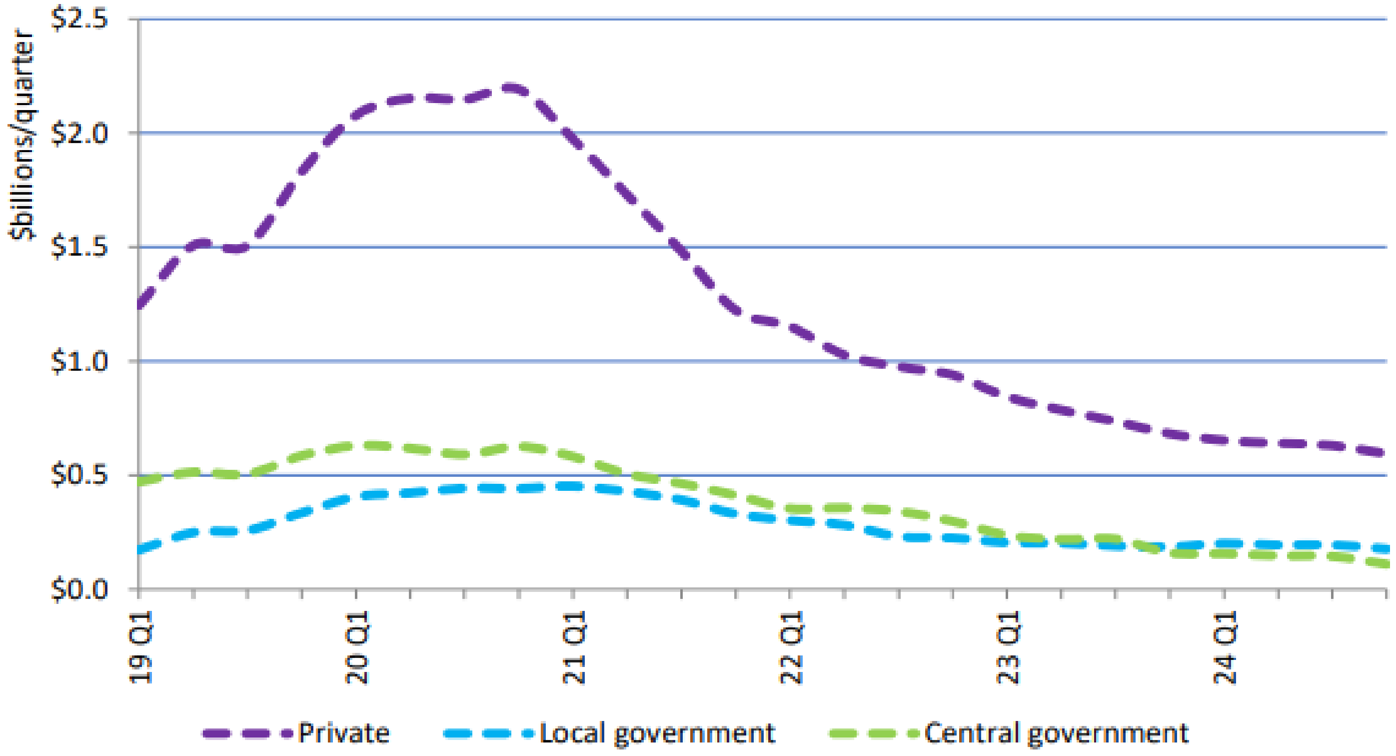


Source: Pacifecon

Facts and Thoughts

- Design – currently very poor = time and cost blow outs
- Council consenting – good & bad
- Procurement - Tier 1 contractors
  - Tier 2 contractors
  - certainty
  - Govt new rules
  - framework model v tender
- Cashflow - offsite payments
- Bonding - 10% v 5%
- Sub contractor contagion
- Accreditation – vertical leaders Group

Q&A

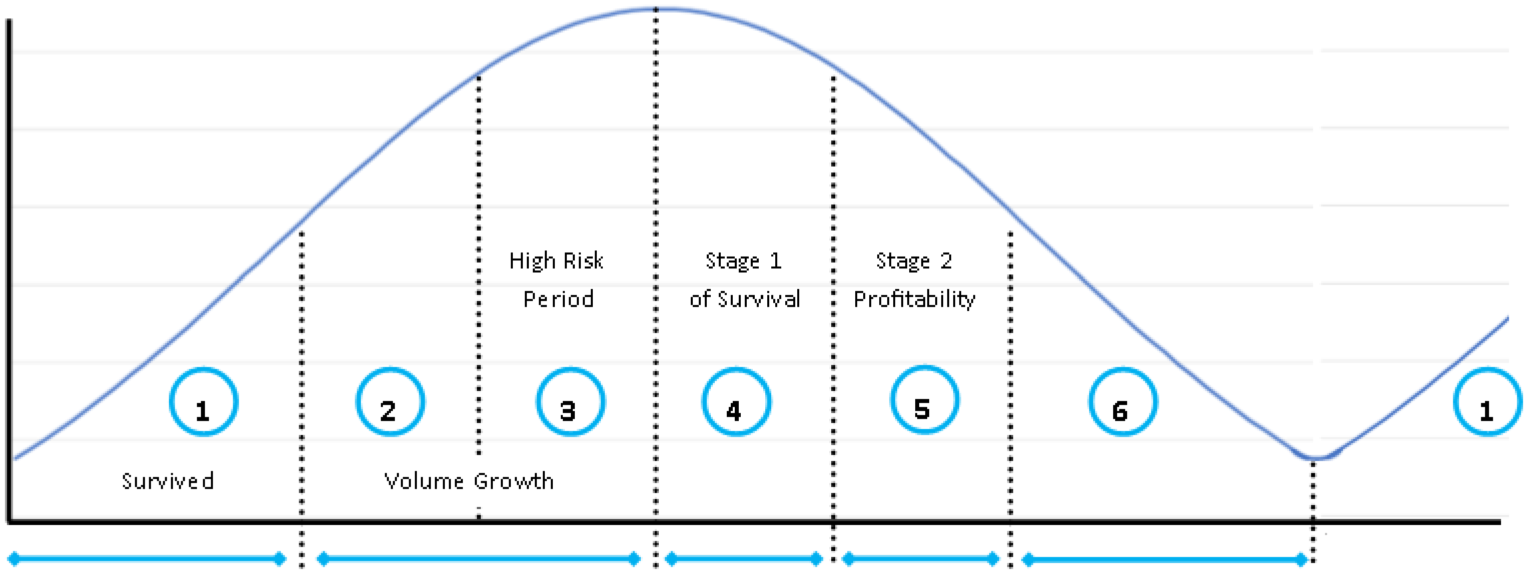
Questions and hopefully Answers

Current Construction Cycle

Current construction cycle is the most dangerous for a contractor

History – Chris Hunter has been through 3 cycles/87 – now 4 cycles
crash/Hartners/McKenna/MZ/Ebert,Fletcher,Arrow/ next?

Construction Risk and Profitability

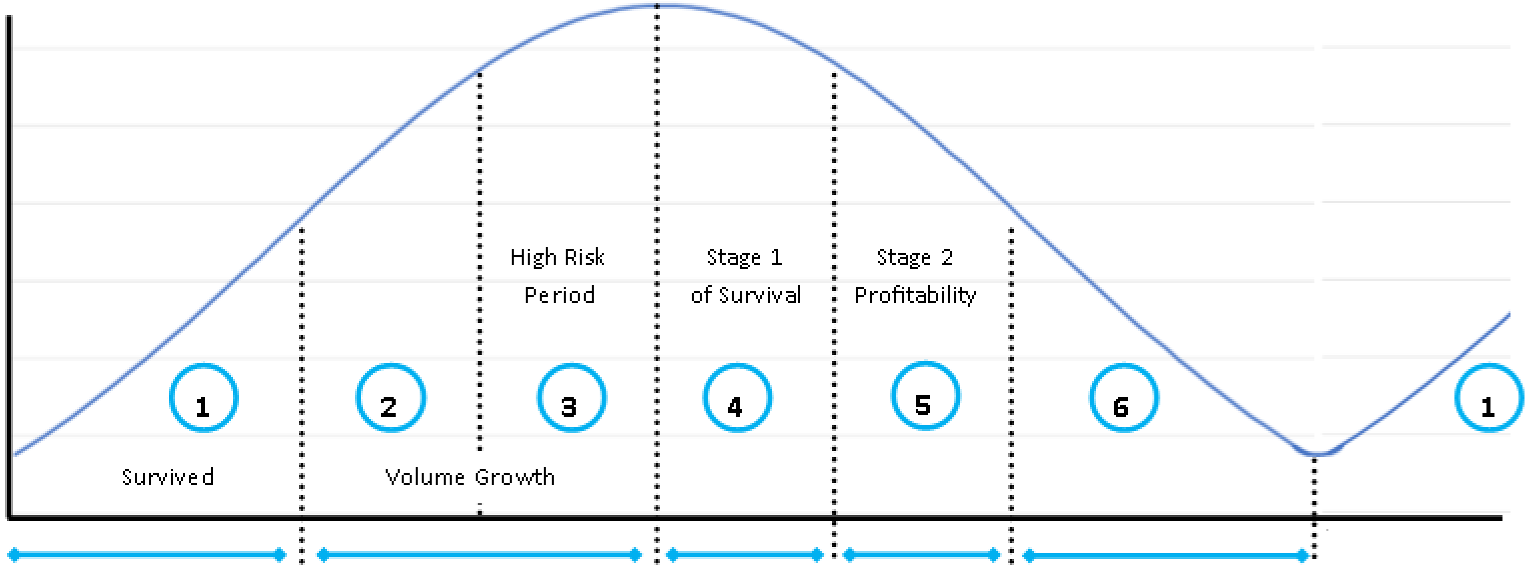


1
- Volume increases of low base
- Main contractor & Subs survive on low turnover and low margins.
- Balance sheet weak

2
- Win more work
- High demand of resources
- Profit increases
- Price increases
- Competition for staff starts

3
- Contractors price at yesterdays rates = profit downgrade
- More working capital required which comes out of profits!
- Increased costs = Profit downgrade
- Sub prices out of control
- Risk transfer unmanageable
- Projects get delayed – LD's & P&G blow out
- Lack of competition
- Failure

Construction Risk and Profitability



4
- Business must adjust to drop in volume
- Old job losses hit bottom line
- Cost cutting of overheads
- Start to see more competition, but prices stay stable
- Main contractors and subs may go into receivership
- High level of latent liabilities arise
- Last man standing risk (contractors & clients exposed)

5
- Continued main contractor and sub receivership
- Competition drives costs down
- Contractors take on more risk
- Profitability on projects slow to return

6
- Lower volume of work
- Profit low
- Further cost cutting

Construction Companies Risk Profile

1980's

- 5% margin
- Mainly building contracts
- Sub warrantees/guarantees direct to client
- Water ingress insurance cover existed
- Design liability predominantly client risk
- Retentions sub's risks
- Paid if paid
- Fit for purpose was client risk predominantly
- Variations were paid + escalation and processing costs

2000 - today

- 5% margin
- GMP/ novated / PPP's – high risk contracts
- Joint + Several now
  - i.e. main contractor steps in and assumes sub obligations and liabilities
- No insurance cover and 10 year main contractor watertight guarantee required

Main contractor consumes some of the risk under new laws and performance specifications/ novation of design

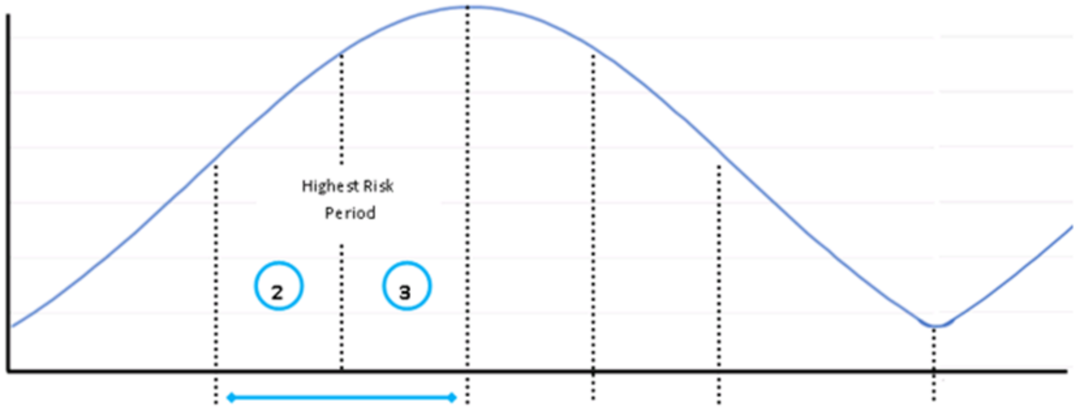
Main contractor assumes risks now under new CCA law changes

Pay even if not paid = big liability on main contractor

- Main contractor fights to stop clients transferring this risk
- Generally restricted via time bar clauses and no escalation + process costs allowed any more

Construction Risk and Profitability

NZ, but particularly Auckland, is in Stage 3 of the construction cycle



A. 2019/20 is forecast as the peak year

B. Cash flow v profit

C. Fletchers chased turnover and have been caught with taking on too much risk

These risks include:

1. Taking on design risk with inability to off load risk to subcontractors
2. Pricing escalation risk poorly – last year Auckland escalation was 8-16%
3. Not enough quality staff to manage risk & poor design management
4. Massive supply chain price escalation and no competition to control cost

D. Subcontractors starting to fail and go into receivership

E. Subcontractor quality poor = time delays, rework costs, LD's called, latent liabilities

F. Projects being consented but funding restriction and cost blowouts squeezing feasibilities and profitability = projects being shelved or major delays

G. Desperate developers trying to pass on too much risk

H. Quality of design at '<u>lowest level ever</u>'

I. Chinese developers/contractors/material imports = big risk

J. Out of town main contractors chasing turnover and risk of local subcontractor market prioritising other incumbent main contractors

How Have We Let Ourselves Take On Too Much Risk

- No real barriers to entry
- Our industry has NO strong voice with teeth to protect our sector
- Too many Contractors prepared to take on risks or don't understand risks
- Too many fly by night Main Contractors! They won't be there when you call on guarantees
- Not looking after our Subs – lowest price (procurement)
- Gate keepers (Procurement officers/PQS/PM's) not protecting industry – lowest price/tender v non price attributes (Value & Out Turn cost)
- Lawyers lack a balanced view on risk transfer
- Government not understanding & leading the drive downwards ie lowest tender procurement
- Accepting poor design & coordination
- Where is BRANZ when the industry relies on them!!

Leadership starts at the top - Government

Horizontal (civil) construction has made ground in terms of:

- Controlling Govt thinking, procurement, and expenditure
- Helping align local Govt & private sector spend and procurement

= Less fragmentation, well capitalised companies = control risk transfer & procurement via value proposition

<u>We must get a seat at the top table and influence our future like the Horizontal Sector has done = Start with a change in Govt Procurement Attitude</u>

In the mean time Managing our Risks

How to handle the risks now and in the future

- Target clients that have counter cyclical spending & diversified project book
- Lower turnover through this period and focus on servicing the project
- Know your scale to handle ups/downs
- Management that stays close to the projects (IP close to coal face)
- Governance with clear strategy on managing/sustaining growth
- Focus on more variable cost than fixed
- Choose the right procurement method & engage Subs early
- Avoid Design & Build contracts v risk contingency (DD & escalation)
- Focus on design quality – don't short change/reduce time frames

Managing Risk

How to handle the risks now and in the future

- Focus on cash flow to support biz
- Focus on profit per person
- Grow retained earning – avoid sucking too much dividends out
- Endorse credit works
- Endorse insurance retention
- Focus on tier 1 subcontractors that will or have shown long term stability and will stand by their warrantees and guarantees
- Be careful around foreign companies quality and longevity

Put **EGO** in a cupboard and don't let it out!!

and last but not least…informed and supportive banking partners.

Don’t Stuff up a Great Opportunity

ECI – Early Contractor Involvement

Feed back to date = poor outcomes & not taking it seriously
=Also clients not necessarily using ECI correctly

- Greatest opportunity to de-risk a project for client/consultants/contractors/Subs
- Everyone wants CERTAINTY
- Design to the budget not price a design
- Get right contractor with the right expertise early
- Get the right Subs on early with the right expertise
- Contractor/Sub to help influence design
- Contractor/Sub help market test pricing at all design stages and share tasks with PQS
- Collaborative approach
- Balanced risk transfer

Price competitiveness can be achieved by 2 staged tendering: 1- Main Contractor P&G, margin, 2- 85% trade tendering = 100% competitive tender pricing

Final Comments

- The industry has a 5-7 years strong work load ahead
- It’s a very positive future for the construction industry - not without risks, but risks that can be carefully managed if you apply the right experience
- We need Teeth!