

BEATING THE MARKET

- 10 KEY OPPORTUNITIES IN 2011

2011 will be another challenging year for construction and property in the GCC region and clients need to be well prepared to get the best out of projects as well as existing assets. In this brief guide, Simon Rawlinson, Head of Strategic Research at EC Harris, reviews the challenges ahead and describes steps that clients can take to ensure success.

2010 turned out to be a much better year than forecast, despite significant problems in many markets. Investments have performed well, business confidence and profitability have improved, and across the world, overall demand for construction and infrastructure has continued to grow.

New challenges will emerge in 2011 in the GCC region. Political uncertainty following recent events in Tunisia, Egypt, Bahrain, Oman and Libya will provide challenges to the commercial viability of projects, although confidence provided by rising energy prices will provide the demand and opportunity to drive many more. Qatar's successful World Cup bid will unlock a long term investment programme, whilst elsewhere in the region, rapid population growth will create demand for housing, infrastructure and wider commercial development.

As recovery in many GCC markets strengthens, 2011 will be a year when positive action will create conditions for success. Clients with a proactive approach to programme and project set-up, procurement and delivery will be best placed to secure value and viability. Those that assume that they can rely on weak demand to obtain best value may not obtain optimum results and may be taking unnecessary risks.

01 Are your existing assets delivering optimum performance?

Intelligent cost reduction may be the answer.

► What is the issue?

As Middle Eastern markets recover from the downturn, management of operating costs and replacement expenditure will create further opportunities to maintain or enhance profitability. Strategic asset management is not widely practiced in the GCC region, so there are plenty of opportunities to eliminate waste. A structured approach to the management of operational costs of built assets can yield significant, recurrent savings between 15 to 20%.

► Why is it significant?

Built asset operational costs are rarely reviewed systematically to identify all opportunities for improvement. This is particularly the case in the GCC where often there is little incentive to drive out unnecessary cost from built assets.

An end to end review of all aspects of the use of built assets - which might include an organisation's working methods and space requirement, provides a powerful means of identifying opportunities to eliminate waste. Intelligent Cost Reduction is a proven, integrated process that identifies and delivers more effective use of assets and more efficient FM, as well as improvements to procurement and detailed supply chain management.

► Action for 2011

Clients adopting structured Intelligent Cost Reduction programmes have been able to release assets for reinvestment as well as eliminate cost. Cost elimination can be focused on reducing the quantum of FM work and increasing the efficiency of FM delivery as well as market-driven cost reduction through procurement and supply chain management. Intelligent Cost Reduction Programmes can often be financed through shared savings - enabling performance improvement to be secured with minimal initial expenditure.

02 Should you select the lowest priced tender?

Be certain that bids are deliverable and proactively manage the delivery phase.

► What is the issue?

Prices for construction in many GCC markets have fallen by at least 25% since 2008. Volumes of work in Dubai, Abu Dhabi and Bahrain are not expected to return to the peaks seen in 2007/8 in the medium term - even though substantial infrastructure investment is in the pipeline. Clients continue to secure very deep discounts through competitive tendering and tough negotiation.

As workload begins to rise, an important question is whether current price levels are sustainable or whether clients are exposed to higher levels of price and performance risk than they should be. Selecting suppliers on the basis of what a project should cost gives greater protection from the consequences of sub-economic bidding.

► Why is it significant?

Prices have fallen deeply in the region since late 2008, but the gap between costs and prices has begun to widen. Deeply discounted and potentially under-resourced supplier bids represent a major delivery risk for clients and on longer programmes, suppliers could find themselves exposed to significant cost inflation. As input costs rise, contractors and their supply chains may find themselves caught out by rising prices, with few options other than to pass price risk to clients through claims and out-turn costs.

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Well advised clients are taking great care in appointing their project team by focusing on the wider benefits of the most economically advantageous bid rather than the lowest price. Their objective is to secure great performance and great value - rather than run the risk of project failure through under-resourcing, poor quality or unexpected cost escalation. Key opportunities include reviewing the procurement strategy, ensuring appropriate completeness and coordination of the client's design or scope, reviewing the bidder's programme and resourcing, and confirming the completeness of the bid and the financial strength of the second and third tier supply chain.

03 Are you delivering your major projects efficiently?

Commercially led programme management may be the answer.

► What is the issue?

Many clients in the GCC region are delivering large, complex programmes of building works and infrastructure. Many clients need to take deep cost savings out of their built asset development and operation costs in order to deliver value and secure investment. Viability challenges such as these need radical thinking from many large clients, as conventional competitive single project procurement cannot deliver the long-term, sustainable savings required.

► Why is it significant?

The division of built asset management into capital projects and ongoing operations and maintenance is a common approach, but may be unsustainable in organisations which are charged with delivering significant, sustained savings. Changing the way in which projects are managed and delivered in an organisation may be difficult to put in place but will ensure that programmes of work are considered in lifecycle terms and are evaluated against principal business objectives.

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Thinking in terms of programmes rather than projects may provide the best opportunities to drive costs out of a client's portfolio. At a simple level, programme management accesses economies of scale for the client and the supply chain. Performance improvements can also be obtained through early planning and programme governance. At the most sophisticated level, commercially-led programme management will involve the full integration of capital and operational spend and benefits realisation through a programme management office (PMO) - directed to meet business outcomes rather than simply project objectives.

04 Could you increase the value of your existing assets?

Focusing on improving asset performance through planned maintenance and targeted refurbishment could add considerable value for relatively little outlay.

► What is the issue?

Whilst there is surplus commercial and residential space in many markets in the GCC region, occupiers and end-users can afford to be more selective in their property choices. Clients are paying more attention to operating costs and asset performance, and buildings that do not measure up could be at risk of premature obsolescence. Below par operation of process plant and infrastructure will also adversely affect the performance of end-users. Developers and owners that invested in the construction and maintenance of durable, high performing assets will continue to secure sustained returns. Where buildings and assets were not built to the highest standards, or have not subsequently been properly maintained - action could be taken to enhance value whilst costs are low.

► Why is it significant?

In a market characterised by short leases and a surplus of space, occupiers are currently calling the shots. Assets developed during the boom may not currently be delivering anticipated returns, but will be competing for occupiers over the next 25 years. In GCC markets, there is currently a clear distinction between modern Grade A accommodation and older space - in terms of age and building type. However, due to issues of design and building quality, a gap is rapidly emerging in used property developed in the last cycle, between Grade A and lower quality space. In European and American markets, planned maintenance and refurbishment are well established routes to optimising the position of an asset in its market place - either defending existing values or repositioning an asset and its potential income stream.

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Consider commissioning a building condition assessment to get a full assessment of the performance of the building to understand whether it is competing with its peers. For all buildings establish a planned maintenance programme which ensures that building performance is maintained in the long-term and warranties can be enforced. For older properties consider investment in refurbishment or refreshment as an alternative to accepting below par rental income.

05 Do your current deals provide best value?

Take the opportunity to check whether current construction contracts and FM contracts could perform better.

▶ **What is the issue?**

Current contracts may not be delivering maximum value, even though headline costs are low. Process inefficiencies, poor visibility of cost and ineffective contract execution may result in unnecessary waste.

▶ **Why is it significant?**

EC Harris audits show that clients are typically paying 3% to 7% too much for work let under long term target price or cost reimbursable contracts. The cause is not just the work itself, but also ineffective processes, interfaces and performance incentives.

▶ **Action for 2011**

Clients can undertake Forensic Cost Audits which will provide a full assessment of costs, management systems, contractor compliance and opportunities to improve efficiency in the supply chain. Critically reviewing projects or programmes with a Forensic Cost Audits review regularly provides a 5:1 return on investment from long-term efficiencies and savings.

06 Is your project safe from supplier failure?

A more rigorous approach to suppliers removing single points of failure from projects may help.

▶ **What is the issue?**

Business failure in property and construction usually peaks at the beginning of the recovery phase. Bankruptcies and liquidations accelerate as workload picks up - as a result of rising prices affecting jobs won on low bids, strained cash flow and actions taken by other creditors to recover outstanding debts.

▶ **Why is it significant?**

Business failure will be a significant risk in 2011 and 2012. The recent downturn has weakened many contractors and suppliers in the GCC region - aggravated by commercial debts that continue to remain outstanding from 2008. Sub-economic work won at the market's trough could expose further financial weaknesses in the supply chain. Furthermore, extended credit terms that are common in the region will continue to place pressure on contractor and supplier cash flows.

▶ **Action for 2011**

Many clients undertake pre-appointment financial health checking, but in the current market, more rigorous vetting of the financial status and workload of suppliers may be appropriate. Procurement routes that enable clients to have a more direct role in the appointment of specialist contractors are also worth considering, such as a hybrid two-stage tender strategy that enables a more detailed review of the second tier to be undertaken by the client before a principal contractor is appointed. Where funding allows, reduced payment periods will improve cash flows in the supply chain, and will make projects more attractive to contractors.

In the current market, clients should be wary of paying large lump sums to contractors for mobilisation or pre-payment if the contractor has significant liabilities - a lump sum payment could trigger recovery action by other, less far-sighted creditors.

07 Has your project got the optimum sustainability strategy?

Long term competitiveness can be protected.

► What is the issue?

Sustainability is increasingly important in the region and low impact built assets will be increasingly attractive to corporate occupiers responding to global performance standards such as LEED as well as their own Corporate Social Responsibility (CSR) agenda. However, the revived commercial market will expect raised environmental performance at little or no extra cost. Public sector building and utility projects will also have to meet tougher sustainability and energy efficiency targets without the benefit of enhanced budgets.

► Why is it significant?

Many occupiers have adopted low carbon operation as a key organisational objective. Capital and FM expenditure programmes on long life built assets need to respond decisively to the low carbon agenda, as lack of progress could accelerate building obsolescence and reduce Net Present Value. Within the GCC region, the introduction of sustainability standards such as Estidama in Abu Dhabi and the Qatar Sustainable Assessment System (QSAS) demonstrate that these factors are as important locally as they are in other strategic commercial locations.

► Action for 2011

Clients should review their sustainability strategy in the light of planned Environmental Regulations - not just current standards. This may involve designing buildings to exceed current standards, or making provision for future low-carbon adaptation. Given the long life of built assets, clients should consider all aspects of the impacts of the building life cycle - from the embodied carbon of construction to eventual disposal. Built Asset clients are in a strong position to act as Thought Leaders for their occupier clients and stand to gain as high performing buildings achieve differentiation and enhanced value.

08 Is your project failing to deliver all expected benefits?

Keep going! Projects can be turned around without putting the completion date at risk.

► What is the issue?

Many large, complex projects and programmes experience challenges during design and construction - sometimes threatening the achievement of project objectives and the attainment of quality, cost and time targets. Whatever the cause, with clear planning, and a focus on priority actions, corrective action can be introduced, turning a project around without putting the programme or end date at risk.

► Why is it significant?

The momentum and complexity of major programmes and projects is so great that once complex performance challenges emerge, it requires real courage and determination to commence corrective action. However, the project objectives can only be met if these decisive steps are taken. Challenges may be caused by one of a number of factors: the brief may require adjustment; the client management organisation may need to be reconfigured; procurement and supply chain strategy might need review; or design, construction or supervision resources may need to be more productive. Although the challenge is great, it is possible to undertake action without downing tools - enabling key targets to be met.

► Action for 2011

If a programme or project needs corrective action, do not delay the initiation of a review process. What's more, don't stop the project! - Maintain programme and initiate a focused Total Risk Management process in order to identify recovery options. Assume that not all proposals will be deliverable and set stretching targets for cost reduction and programme acceleration so that the overall recovery challenge is met. Use short-term campaigns in order to break the problems down into 'manageable chunks' to motivate change action, and to create individual accountabilities within the project team.

09 How high could commodity prices rise?

Alternative strategies for sharing inflation risk.

► What is the issue?

Prices for many commodities reached post-crash highs during 2010. According to the IMF, copper prices have risen by 30% year on year, and with demand exceeding supply, prices are expected to stay high. 2011 began with price warnings for oil, iron ore and coking coal, and political instability in the Middle East could trigger further inflation. Built asset clients can take steps to protect themselves from the risk of imported inflation from commodities.

► Why is it significant?

Commodity price escalation was one of the most potent cost drivers during the 2007/8 boom, when manufacturing input prices increased by over 30% year on year. Commodity price-driven inflation is a reality in GCC markets where labour costs are relatively low. Changes in commodity prices will have a greater effect on overall cost than they do in Europe or the US. With global consumption of commodities growing rapidly, short term shortages for in-demand materials can be foreseen and mitigated.

► Action for 2011

A number of clients have chosen to manage the risk of commodity price actively - rather than pass all of the risk to be priced by the supply chain. Clients have a number of options when managing commodity price risk, including designing to minimise use of commodities, as well as hedging strategies which can involve either the purchase of options or direct investment in physically-backed commodities funds. Sharing the price risk with suppliers can help to avoid a wider inflation premium in competitive bids, driven by the bidders' perception of risk - a major challenge in 2006 to 2008. Under these arrangements, clients should only pay their agreed share of commodity price inflation if the cost escalation actually takes place.

10 Are you backing the right projects?

Focus on building performance as well as iconic design in 2011.

► What is the issue?

Built asset owners are increasingly sensitive to the performance of assets including buildings and infrastructure. Built assets need to be commissioned, delivered and operated to drive overall business value. Clients in the Corporate Real Estate sector, for example, are increasing more demanding of their landlords - expecting better quality buildings that have more useable, productive and valuable space to enable them to outperform in their own markets .

► Why is it significant?

Future built asset development must deliver an exceptionally competitive product to address a corporate real estate agenda focused on flexible working, reduced costs of occupancy and a reduced environmental footprint. Adaptable buildings should be designed from the inside-out to deliver long term, high performance at the competitive price levels currently set by the market.

► Action for 2011

Customer-focused clients are prioritising optimum life-time performance in their developments. Their objective is to deliver buildings with high development efficiency, low operating costs and space that deliver high occupier productivity. Successful clients will supplement a robust brief with an effective, collaborative project team, fully focused to deliver this need on investment in performance-enhancing buildings.

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