

Construction – A Risky Business

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Builders are Foundering

*But do wrecked projects
help the client?*



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Agenda

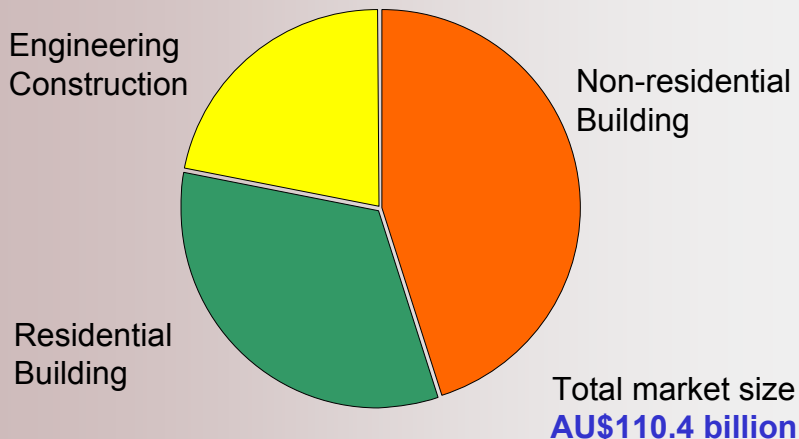
- The Australian Construction Industry
- Workload & Profit – Trends
- Risk Factors
- Risk Management Strategies
- Options for success the 21st Century

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The Australian Industry



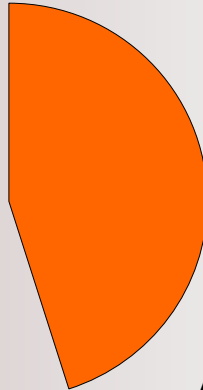
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The Australian Industry

Offices
Factories
Religious
Education
Health
Retail
Entertainment
Hotels
Other Business
Misc



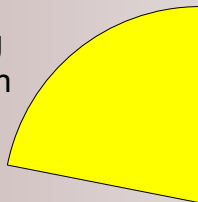
Non-residential
Building

Predominantly large and
medium sized contractors

Approximately
AU\$50 billion

The Australian Industry

Engineering
Construction



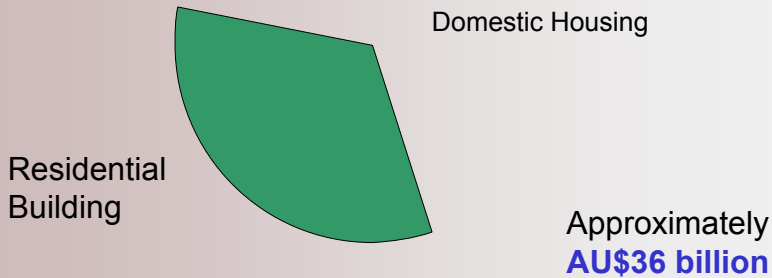
Telecommunications
Roads & Railways
Bridges
Recreation
Pipelines
Sewage & Water
Mineral processing
Harbours
Electricity
Other Heavy Industrial

Predominantly large and
medium sized contractors

Approximately
AU\$24 billion

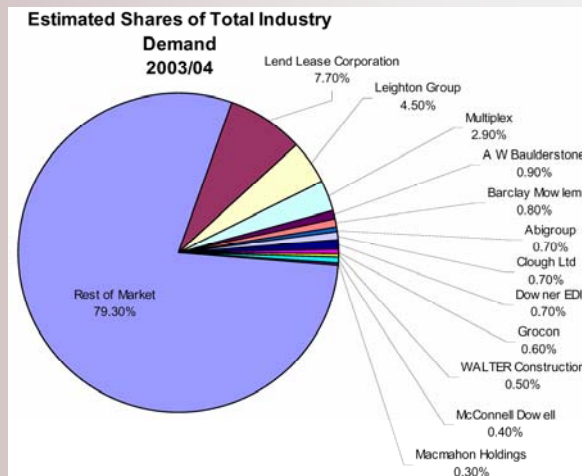
The Australian Industry

Predominantly small and medium sized contractors



The Australian Industry

Dominated by a few major contractors



The Australian Industry

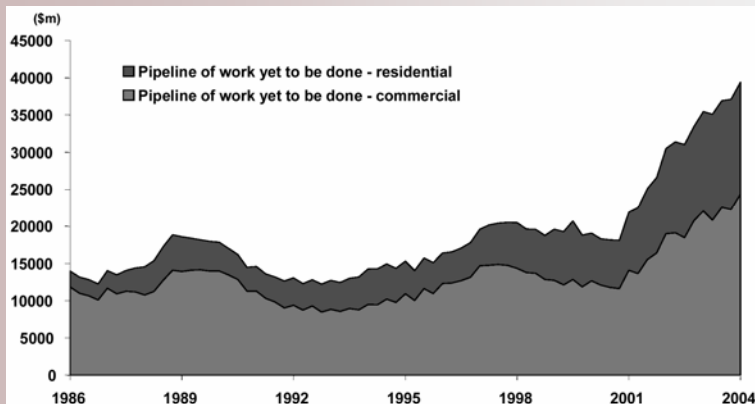
- Major Contractors
 - Consolidating and reducing in #
- Medium Contractors
 - Perennially squeezed
- Small Contractors
 - Domestic construction
 - Subcontracting to larger businesses
 - Very low entry threshold

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Australian Industry - Trends



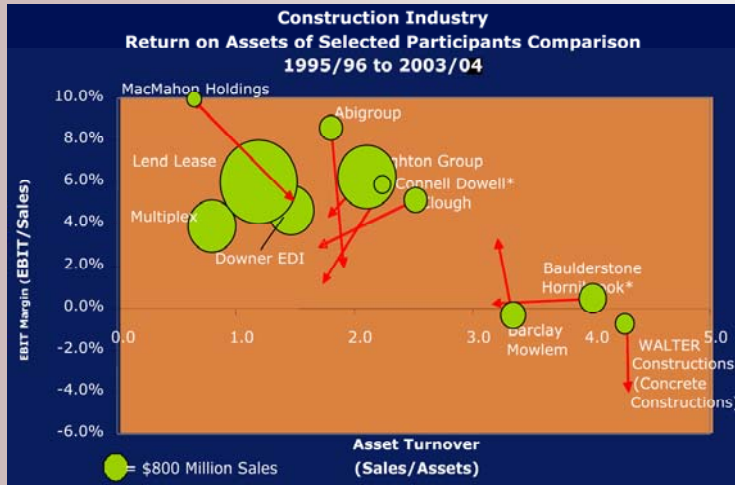
- Market approaching its peak

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Australian Industry - Trends



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Australian Industry - Trends

- EBIT Margins are now 2% and falling
- Costs are rising
 - Tender Price Index
 - 2003 +7.0%
 - 2004 +7.5%
 - 2005 +5.7%
 - 2006 +5.0% (estimated)
 - 2007 +5.0% (estimated)

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Australian Industry - Trends

- Failures and Consolidations Increasing
 - Walter Construction Group – bankrupt
 - Henry Walker Eltin – bankrupt
 - John Holland – bought by Leighton
 - James Hardy – bought by Multiplex
 - Simon Engineering – bought by Abigroup

Key Risk Factors

- Material Cost Escalation
 - Concrete +14%
 - Steel +30% (some +50%)
- Labour Shortages
- Security of Payments Legislation
 - Adjudication
- Industrial Relations
- Government Legislation - 3 levels

Risk Mitigation Strategies

“Life is either a daring adventure or nothing. Security does not exist in nature, nor do the children of men as a whole experience it. Avoiding danger is no safer in the long run than exposure.”

Helen Keller, US blind & deaf educator (1880 - 1968)

- Clients are ‘building to own’ but....
- Transfer all risk to the contractor
 - Prefer D&C Contracts
- Use ‘Fixed Price Contracts’

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Risk Mitigation – D&C Contracts

- D&C Contracts are ‘preferred’ as a low risk option by many Australian clients and finance institutions



But is it wise to put all of your eggs in one basket?

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Risk Mitigation – D&C Contracts

- D&C Contracts transfer design control to the lowest bid designer working for the lowest bid contractor
- The cheapest design is not necessarily the best option for the next 50 years

Risk Mitigation – D&C Contracts

- Low Bid' D&C Contractors accept the design risk at builders margins
- Builders losing money tend to cut corners to save costs (reduce supervision and quality)
- Generate claims to recover loses – Facilitated by the SOP Legislation

Risk Mitigation – D&C Contracts

- Costs incurred by the client
 - Rectifying quality defects
 - Defending Claims (litigation)
- Can significantly outweigh initial savings

Without effective client involvement D&C is a very high risk choice for 'build to own' clients!

The Ultimate Risk is Always with the Client!

- Walter Construction Group clients had 'a single point of responsibility'
- The cost of completing work after the builder has failed can be double the original cost!

Options for the 21st Century

- Clients are responsible for deciding how to procure their buildings
- Clients select the procurement strategy
- Clients define the risk profile
- **But builders do not have to 'buy' work at uneconomic prices!**

Options for the 21st Century

- Every builder knows that not winning work will destroy its cash flow and it will go bust
- **But** – winning work at uneconomic margins only delays the process
- **And** – hurts more
 - Particularly now subcontractors have access to the SOP legislation

Option 1 – Buy What you Need

- A Shire Council buys mains water and sewage treatment based on the volume consumed (price per mega litre)
- The contractor is responsible for the construction and operation of the facilities for 50 years

Option 2 – Focus on Profits

- BP Retail makes its money from selling petrol and consumer items
- The construction of its service stations is managed via long term partnering arrangements with skilled designers, planners and builders

Option 3 – Client Engagement

- Clients becoming involved in ‘their’ project and working to achieve desirable outcomes
 - Collaborative Working Agreements
 - Alliance Contracts
- Proactive risk management



Required Cultural Changes

- Increased professionalism both from the industry and its clients
 - More qualified practitioners (MCIQB)
- Better contracting processes
 - Allow builders to make a profit!
 - Expect value (not low cost)
 - Manage the whole contract
 - Focus on outcomes

Required Cultural Changes

- Embrace risk
 - Pro-active management
 - Allocate risk in proportion to reward
 - Allocate risk to the party best able to manage it
 - Risk can have positive outcomes as well as negative!

Conclusion

- The risk profile for building in Australia is changing
- Smart contractors and clients will work together to deliver great buildings
 - The tools are already available
- The alternative is more failed projects!
 - And more failed builders.

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Thank You

Copies of these slides (and the paper) are available from
www.mosaicprojects.com.au (from the 'resources' area)