RETHINKING CONSTRUCTION

2021 BDO NEW ZEALAND CONSTRUCTION SECTOR REPORT

Rethink

BDO

INTRODUCTION

The opportunities and challenges inherent within New Zealand's construction sector have always been amplified by its cyclical nature, a theme demonstrated over our three previous editions of the annual BDO New Zealand Construction Sector Report. However, the disruptive forces brought about by the global COVID-19 pandemic are different and have necessitated a rethink regarding the most effective strategies to operate successfully in and drive the sector forward from its current market position – building a foundation for broader economic growth and sustainability of the sector.

The sector story since the pandemic

Gross profit margins provide a quick snapshot of the sector and its strength or otherwise. From 2018 to 2020, margins slowly improved from their previous weak levels. By March 2020, just before the impacts of the COVID-19 pandemic took hold, New Zealand's construction sector was in strong health. Unfortunately, the ensuing lockdowns quickly destroyed confidence in the sector, with some companies losing virtually all of their planned forward work, and others losing a substantial portion. Affected companies then significantly reduced their pricing and margins as they were desperate to secure work for their employees. Some of those companies are doing those projects now and are treading water and struggling to make sufficient gross profit to cover overheads.

On the upside, with reduced interest rates, travel restrictions and other changes, the demand for buildings - particularly housing - has picked up, and many companies experienced a better year in 2021 than in 2020. Our 2021 report highlights that forward work has rebounded to be particularly strong; an encouraging sign.

Re*think* required

KEY SECTOR CHALLENGES - WHERE THE RETHINK IS REQUIRED

New approaches are evident in the sector today in response to market challenges, including;

- upskilling of existing staff due to labour supply challenges,
- fresh approaches to procurement in response to material shortages,
- changes to negotiating and pricing contracts due to inflation, and
- attempts by construction businesses to reallocate some of these risks.

However, despite this adaptability, there remain some key challenges within the New Zealand construction sector – where a further rethink and more change is required.

Rethinking product supply chains:

The greatest challenges highlighted within the 2021 report are product shortages and significant inflation in both material costs and wages. In response to these challenges, particularly product shortages, we are seeing a greater prevalence of construction firms ordering in advance of when materials are required and stockpiling. This works well for those that can get the products but makes it more challenging for those who can't and the resulting imbalance in supply is adding to the problem and driving inflation even more.

SUPPLY CHAINS

THE GREATEST CHALLENGE HIGHLIGHTED WITHIN THE 2021 REPORT IS PRODUCT SHORTAGES AND SIGNIFICANT INFLATION IN MATERIAL COSTS AND WAGES.

Rethinking a response to inflation:

Many of the cost increases are now in double digits. As most contracts are at fixed prices and the level of inflation has exceeded expectations, gross margins will be significantly eroded, and some companies are already making losses on projects where profits were previously envisaged.

Many have already rethought and changed the way they negotiate and manage this risk for new projects, while others are struggling to find a solution that allows them to win work but not commit themselves to absorbing unquantifiable cost increases. The industry is yet to find a suitable solution

INFLATION

MANY INCREASES IN MATERIAL COSTS AND WAGES ARE NOW IN DOUBLE DIGITS.

Rethinking skilled labour supply:

The next greatest challenge; the acute shortage of staff for the available work is well known and not unique to the construction sector. Employers have responded with significant increases in salary and wages and other initiatives in an attempt to retain staff. However, on their own, these changes do not quickly produce the additional skilled labour the industry desperately needs.

LABOUR SUPPLY

EMPLOYERS HAVE RESPONDED WITH SIGNIFICANT INCREASES IN SALARY AND WAGES.

WITH THESE FACTORS COMBINED, THE SECTOR IS HEADING INTO VERY CHALLENGING TIMES. CONSTRUCTION BUSINESSES THAT ANTICIPATED, PLANNED AND NEGOTIATED CONTRACTS FOR THESE CHALLENGES SHOULD PERFORM WELL. HOWEVER, NOT EVERYONE IS IN THAT SITUATION AND WE MAY WITNESS SOME COLLAPSES WHICH WILL COMPOUND THE CHALLENGES.

The importance of a healthy construction sector is clear. Looking ahead through 2021 and beyond, maintaining a strong and vibrant construction industry will be vital for supporting New Zealand's economy and infrastructure. There are challenges ahead, many highlighted in this report. Construction companies, individually and collectively, are already and need to continue rethinking solutions and taking actions to mitigate the risks and improve resilience to them.

ABOUT THE REPORT

The 2021 BDO Construction Sector Report aims to create an accurate snapshot of the current state of New Zealand's vertical construction sector and the organisations within to find opportunities for growth and improvement - within the context of an industry and economy facing unique challenges due to impacts of the global pandemic, product shortages and responses to them.

Who participated?

Shareholders, directors, as well as senior staff members from all sectors of the vertical construction industry participated in this survey. This includes a strong mix from the housing (51%) and commercial (42%) sectors, split between head contractors (67%), subcontractors (20%), and others.

When and how was the survey conducted?

Data was collected during May and June 2021. 2020 comparative data was collected from July 2020 following the first 2020 lockdown. Questions were digitally sent to the survey participants.

For more:

Scan the QR Code or visit bdo.nz/construction for BDO's latest New Zealand and international construction sector insights.

FOUR PRIORITY AREAS

Our 2021 report has focused on uncovering insights under four priority sector themes

FINANCIAL FOUNDATIONS

GROSS MARGINS – HEAD CONTRACTOR & SUB CONTRACTOR

FORWARD WORK POSITION

LOSSES FROM CLIENT/CONTRACTOR FAILURES & DISPUTES

CASH RESOURCES

TENDER SUCCESS RATE

SUPPLY & INFLATION

SUPPLY CHAIN CHALLENGES

PROJECTS DELAYS

INFLATION IS UNDERWAY

LABOUR SUPPLY & SUCCESSION

STAFF SHORTAGES

RELIANCE ON WORK VISAS

SUCCESSION PLANNING

MANAGING RISK

UNREASONABLE RISK TRANSFER

RISK ACCEPTANCE

RETENTIONS REGIME

IMPARTIALITY OF ENGINEERS TO CONTRACTS

REPORT FOUNDATIONS: SETTING THE SCENE

KEY ISSUES AND CONCERNS

Verbatim comments shared by survey respondents typically offer an open window to their mood and frame of reference. An analysis of the verbatim comments provided in response to open ended questions in the 2021 BDO Construction Sector Survey highight that issues relating to materials, staff and central and local government are top of mind for New Zealand's construction sector firms.

KEY
- Most common issues
- Common issues
- Other issues raised

1 MATERIALS

60% OF RESPONDENTS

Current and future issues with materials, including both availability and pricing were identified, including:

Most common issues:
- Rising material costs
- Availability of materials, especially important materials like steel and timber with particular emphasis on supply chain delays

Common issues:
- The timely supply of materials
- Material shortages

2 STAFF

54% OF RESPONDENTS

Staff matters identified include:

Most common issues:
- Retention of key staff
- Rising labour costs including the wages and salary expectations of new staff
- Sourcing new staff
- The lack of skilled workers in the NZ economy
- The ability to find appropriate contractors when required

Common issues:
- Young or newly trained staff leaving for higher pay elsewhere
- Quality of staff
- Rival companies poaching staff
- Contractors over committing themselves

3 GOVERNMENT LEGISLATION

21% OF RESPONDENTS

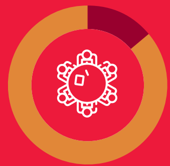
A number of issues were raised in relation to Government legislation, including current policies and future policy changes. Current policies and areas where respondents had concerns include:

Most common issues:
- Immigration restrictions

Common issues:
- Shovel ready projects not actually being ready
- Health and Safety legislation
- Lack of infrastructure

Other issues raised:
- The new sick leave policy

4 COUNCILS



14% OF RESPONDENTS

Issues with councils identified by respondents include:

- Delays for inspections
- Delays for consenting

- Compliance
- Costs

- Other perceived red tape

5 FORWARD WORK

14% OF RESPONDENTS

Issues raised in relation to forward work include:

- Inconsistency of forward work

- Uncertainty within the market
- Down time while seeking work
- Projects not staying on time, putting significant pressures on subcontractors

- Project delays
- Insufficient forward work pipeline

6 FINANCIAL FACTORS

13% OF RESPONDENTS

Financial factors identified by respondents include:

- Profitability, including the impact of the rising staff and material costs on profitability
- Gross margin concerns and pressures, such as lowball bidding which can lead to a race to the bottom

- Cashflow challenges

7 OTHER FACTORS

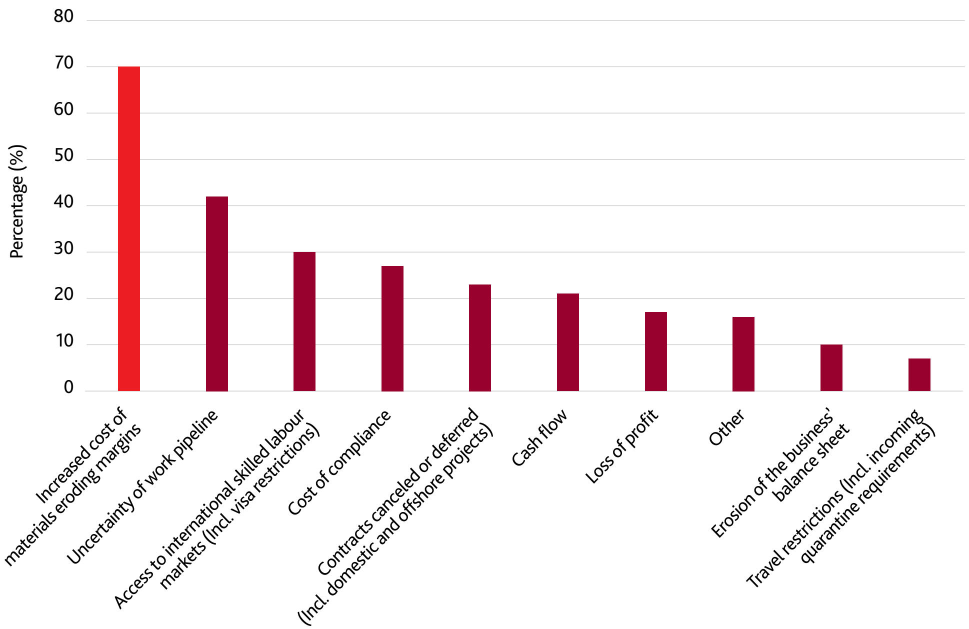
Other factors of concern to survey respondents include:

- Macroeconomic factors such as:
  - Pending inflation
  - Potential future lockdowns
  - Ageing workforce
- Quality of design documentation
- Lack of or concerns around succession planning
- Quality of workmanship
- Bonding capacity
- Transfer of risk
- Land cost and availability

COVID-19 IMPACTS

The standout impact of the COVID-19 pandemic for the construction sector has been the increased cost of materials due to supply shortages. The direct impact of this is a reduction in gross margins where these costs could not be passed onto clients. The pandemic also initially created greater uncertainty in forward work pipeline. Having no access to international skilled labour was highlighted as an adverse impact by 30% of respondents when surveyed (June 2021), and is likely to have an even greater impact at the time of writing.

Adverse impacts of Covid-19 on your business



70%

SEE INCREASED COST OF MATERIALS ERODING MARGINS AS A MAJOR ADVERSE IMPACT OF COVID-19 TO THEIR BUSINESS

SUPPLY AND INFLATION

Supply chain challenges

While non-availability of construction products and materials arising from disruption to production and shipping was an expected consequence of the global pandemic, supply chain challenges have progressively worsened over the past 12 months, evolving into the major challenge it is today.

Many construction companies detailed long lists of products and materials where supply is problematic. Specific items causing the most problems for respondents include:

- STEEL
- TIMBER
- PLYWOOD
- APPLIANCES
- OTHER IMPORTED MATERIALS

These supply issues are not unique to New Zealand; they apply around the world and in many cases seem to be getting worse. Therefore, we cannot rely on the rest of the world to solve these challenges for us and it will take some time to significantly improve. Fortunately, most products do arrive; just late, or some substitution is possible.

Re*think* required

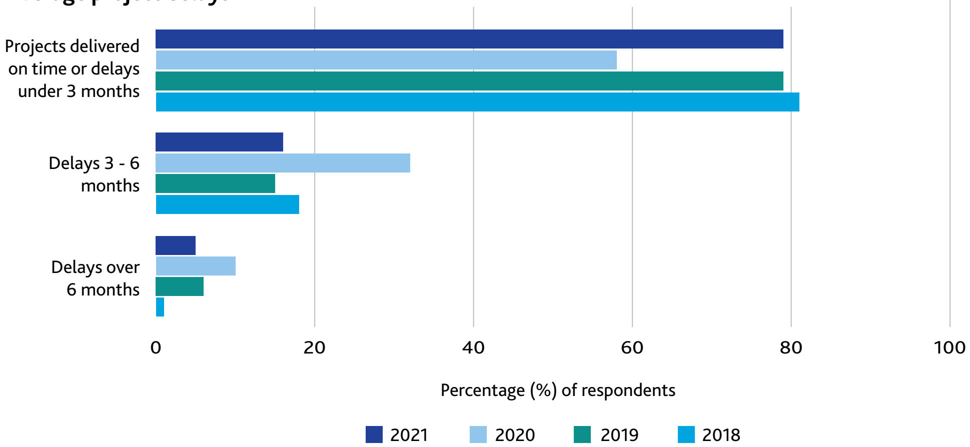
The sector has been quick to rethink and apply new strategies to these challenges. Procurement teams are tracking individual shipping movements to know where their materials are. They are identifying alternative suppliers in case their historical supplier can't deliver. Materials are being ordered and stored well before they are needed. Fortunately, clients can see the benefit and there is now a massive increase in off-site materials claims. Previously such claims would seldom be approved.

Project delays

WHILE PRODUCT SUPPLY CHAIN CHALLENGES ARE NOW THE LARGEST SINGLE CONTRIBUTOR TO PROJECT DELAYS, THERE HAS BEEN NO SIGNIFICANT CHANGE IN THE OVERALL NUMBER OF PROJECT DELAYS SINCE 2019 (PRE-COVID-19 LEVELS).

While 21% of projects are being completed very late (more than 3 months), the number of project delays is on par with 2019 levels. Delays due to product non-availability are generally limited to under three months.

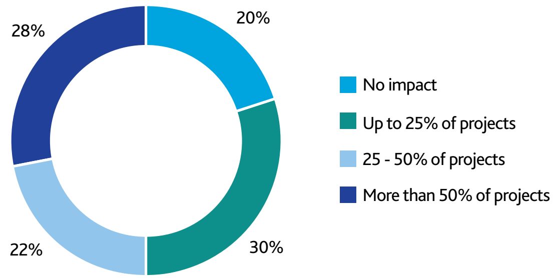
Average project delays



HALF OF THOSE SURVEYED NOTED AT LEAST 25% OF PROJECTS WERE DELAYED DUE TO UNWIELDY BUREAUCRACY.

Respondents highlighted another key cause of delays is council processes and the impacts of unwieldy bureaucracy. Replies indicate that these delays add on average, six weeks, but generally under ten weeks, to project completion times.

Proportion of projects delayed due to unwieldy bureaucracy:



Common consequences of delays include:

- **Liquidated damages** – a penalty the builder pays for being behind schedule
- **Reduced margins** due to staff and equipment being on site for longer than planned
- **Disruption** to the planned work schedule which impacts on subcontractors scheduling and availability to start when needed
- **Delayed occupation** which prolongs interest costs and disrupts tenants moving plans until the building can be occupied

Re*think* required

Project delay challenges have been getting progressively worse, despite the new procedures adopted to manage them. This is going to require a rethink and modified contract terms so that risks do not sit unfairly on a party who has used best practice procedures, but simply can't get the materials needed on time.

Inflation is underway

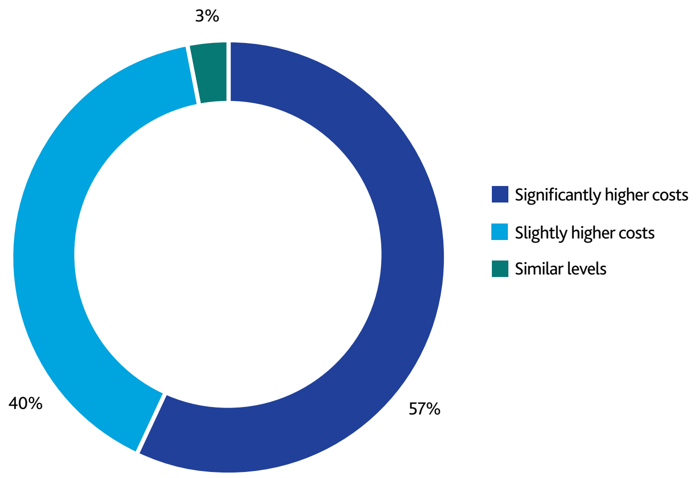
Builders and construction companies are receiving supplier emails advising of price increases weekly. Often, price increases exceed the gross margin of many companies. The issue is not restricted to materials; the acute shortage of labour in the sector is significantly forcing up labour costs too. The inflation challenges on this sector are dramatically greater than the CPI.

We have been through a prolonged period of low inflation and most building contracts have a fixed price. We asked about the extent that these costs are expected to flow onto clients.

INFLATION IS NOT A RISK THAT THE CONSTRUCTION INDUSTRY HAS CAPACITY TO ABSORB. IT IS A RISK THAT NEEDS TO BE PASSED ON TO THOSE BEST EQUIPPED TO ABSORB IT; THE CLIENTS. THE MAJORITY OF CONSTRUCTION FIRMS EXPECT SIGNIFICANTLY HIGHER COSTS TO FLOW ONTO CLIENTS.

Initially builders and subcontractors were being forced to absorb the price increases. That is not sustainable, and practices need to quickly change.

Expectation of rising costs flowing onto clients



Industry players face key challenges; estimating these price increases in order to still provide a fixed price, or changing contract terms so that the client takes the bulk of the risk. Possible approaches include:

- **P & G (preliminary & general) plus margin.** In these situations, the client takes the risk of price increases. The disadvantage is that this does not motivate or reward the builders and subcontractors for innovating and developing more efficient processes, which ordinarily would give them a better margin.
- **Indexing or tagging key materials.** Here, the client takes the risk just for the indexed/tagged materials and certain labour costs. This was implemented in the 1970's and 1980's on some contracts, but most of the people that knew how it worked have retired. The industry standard contract, NZS3910, has a mechanism, but most people do not know how to apply it.

These increases are already impacting margins with expectations around future margins being very pessimistic and variable. As noted elsewhere, this is now the greatest concern of respondents and likely the greatest emerging risk to the strength and survival of industry participants.

Rethink required

How the industry manages inflationary pressures will require a further rethink. It starts with an education component among clients. Determining a likely final contract price will be challenging as each subcontractor and each materials supplier will want the ability to pass on increases that are more than modest. The head contractor/builder must collate these into a winning bid, a very challenging task. The client won't be able to easily select a builder based on price alone. Perhaps non-price attributes will become a greater factor in builder selection - a selection criteria that the industry clearly indicated they wanted in the BDO 2020 construction survey.

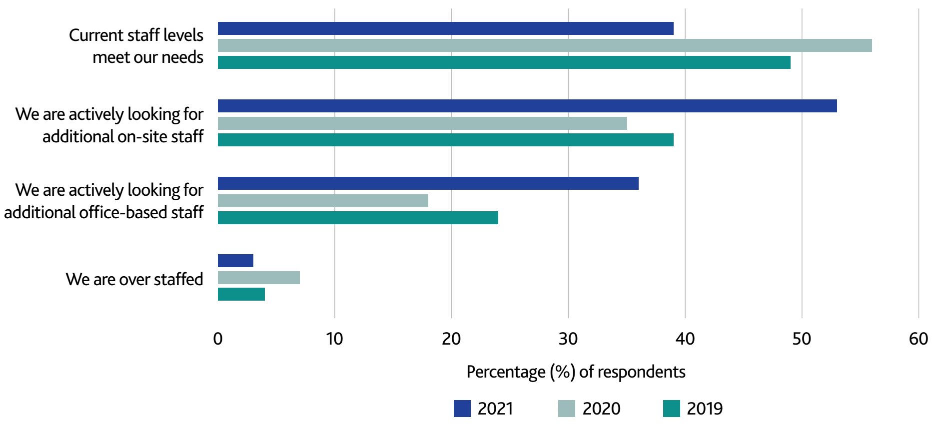
LABOUR SUPPLY & SUCCESSION

SKILLED CONSTRUCTION STAFF SHORTAGES ARE AT THE HIGHEST LEVELS SINCE FIRST REPORTED

Staff Shortages

Shortage of skilled staff was a standout issue in the 2019 BDO Construction Report, easing post lockdown in 2020 and now rebounding to be one of the greatest challenges facing the sector. This is a significant and longstanding issue, amplified by the strong cyclic nature of the sector and the current very high demand for both new housing and commercial buildings.

Current staffing status

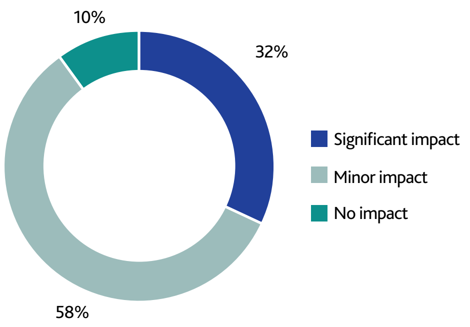


Winning the war on talent is a major focus for management and will only get tougher when the bubble with Australia is open. Salaries and hourly rates are a big lever in the talent war which is making the sector more desirable to work in. However, in the short to medium term, this adds sizable financial pressure for construction companies.

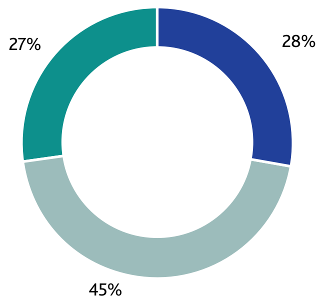
Impact of immigration restrictions on labour

The industry is desperately short of labour capacity. While we must recruit and train staff in New Zealand, we are heavily reliant on immigration to fill our needs and provide a buffer to assist manage the cyclical nature of the industry. The closed border to new staff is a major factor in the current staff shortages. Survey responses show it is most felt in the larger construction companies that contribute the majority of the new houses and buildings by value.

Impact of immigration restrictions - Turnover over $100m



Impact of immigration restrictions - Turnover $60k - $100m



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Once talent has been attracted, the sector needs to keep its people highly motivated so they want to stay working within it. This requires organisations to create a culture that recognises the needs of a younger workforce and stands them apart from their competitors."

James MacQueen

Advisory Partner, Construction and Real Estate Sector National Leader, BDO Auckland

The implications of COVID-19 and the border closures has meant many overseas workers have returned home or cannot enter the country.

This has resulted in a significant shortage of experienced workers for the construction industry. Previously, our local supply of experienced carpenters and construction staff (construction managers, project managers, site managers, quantity surveyors and estimators) has not been able to fill the demand and the gap was closed with overseas workers. Local carpenters also typically prefer residential projects, so this has exacerbated the shortfall in the commercial building sector.

COMPLEX PROJECTS NEED THE EXPERIENCE THAT IS GAINED ON LARGE OVERSEAS PROJECTS. THAT KNOWLEGE CAN THEN BE PASSED ONTO THE NZ WORKFORCE. SERVICING SPECIALIST EQUIPMENT ALSO OFTEN NEEDS PEOPLE TO TRAVEL FROM OVERSEAS. WITHOUT ACCESS TO THEIR EXPERTISE, WE ARE CONTINUING TO INHIBIT OUR PRODUCTIVITY GROWTH AND TRANSFORMATION OF THE SECTOR.

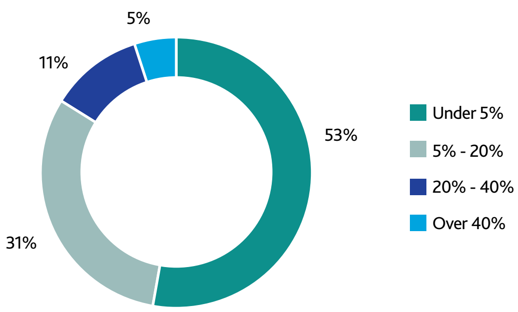
Reliance on work visas

Construction businesses with larger turnover ($10M+) typically need to employ a greater number of staff and therefore have more reliance on immigrants with temporary work visas. Non-renewal of their work visas presents significant risk to these companies and the whole construction sector.

HALF THE INDUSTRY PARTICIPANTS WOULD BE MASSIVELY DISRUPTED IF EXISITING WORK VISAS ARE NOT RENEWED OR REPLACEMENT IMMIGRANTS PERMITTED TO ENTER NEW ZEALAND.

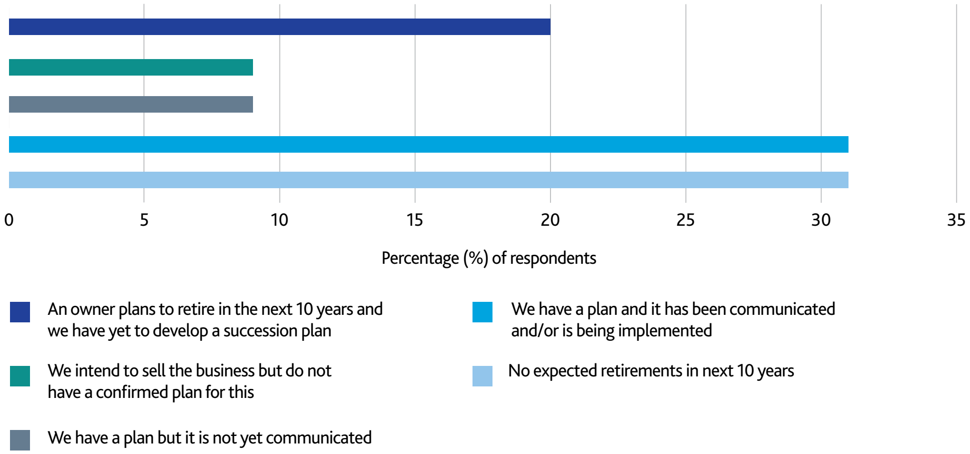
The graph below highlights the scale of that risk for construction companies with turnover over $10m.

Proportion of staff reliant on visas to work in New Zealand



Succession planning

Succession and exit plans indicate a pending change of guard



NOT ONLY IS THE INDUSTRY SHORT OF SKILLED STAFF, BUT OVER THE NEXT 10 YEARS IT WILL LOSE THE EXPERIENCED LEADERSHIP ACROSS NEARLY 70% OF THE ORGANISATIONS IN IT. THAT LOSS OF EXPERIENCE IN AN INDUSTRY WITH HIGH RISKS, LOW MARGINS AND DRAMATIC CYCLES IS LIKELY TO AMPLIFY THE 2 TIER NATURE OF THE SECTOR.

Impact of succession and labour challenges

We are seeing a two-tier construction sector model evolving:

- **Tier 1:** Robust, well managed construction businesses, with strong client demand
- **Tier 2:** Weaker businesses, without the resilience and experience to manage shocks and risks

Company culture, systems and training all play a part in attracting, retaining and developing the best people for future leadership and ownership.

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BDO are actively assisting a significant number of organisations with their succession planning. Companies in the sector are seldom sold to a stranger or on the open market, particularly head contractors. A well-managed succession plan provides the best outcome for the retiring owner, the business and the new owners.

The journey normally takes five years including preparation for sale, negotiating the deal and making progress with payments. If there is no heir apparent, or the likely purchaser needs to be found or groomed, up to 10 years is more common. It therefore pays to start early. The other reason to start early is to manage the consequences of the tough periods in the economic cycle when profitability and value are depressed.

The changes in business leadership and ownership that will occur over the next few years provide a massive opportunity for those who work in the sector"

James MacQueen
Advisory Partner, Construction and Real Estate Sector National Leader, BDO Auckland

Re***think*** required

Often the ideal business purchaser has a young family and existing debt on their home. This does not exclude them from a succession plan. There are techniques to successfully implement a succession plan and allow the owner to extract their investment plus a premium.

FINANCIAL FOUNDATIONS

Gross margins

The majority of head contractors with turnover greater than NZD$10m have experienced growing or consistent gross margins over the past 12 months. Only 27% of head contractors in this category experienced a decline in gross margin ***(see Figure 1)***.

*Head contractors with turnover less than NZD$10m have not experienced the same improvement in gross margin over the past 12 months, with 49% showing a decline in gross margin **(see Figure 2)**.*

Gross margins decreased for the majority of subcontractors (62%) over the past year - likely due to rising wage and materials costs in the subcontractor market which haven't been able to be passed onto clients. Project delays are also likely to have been an influencing factor on this trend. ***(see Figure 3)***.

Figure 1: Gross Margins for Head Contractors greater than $10m turnover

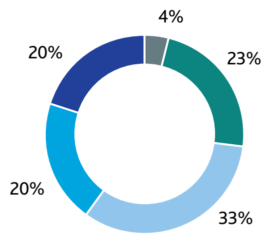


Figure 2: Gross Margins for Head Contractors less than $10m turnover

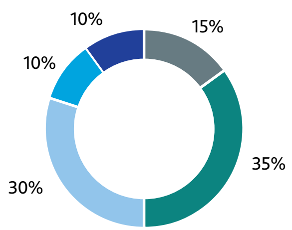
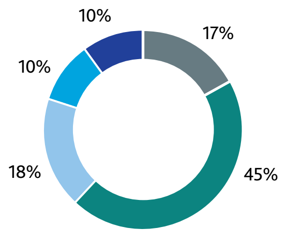


Figure 3: Subcontractor gross margins



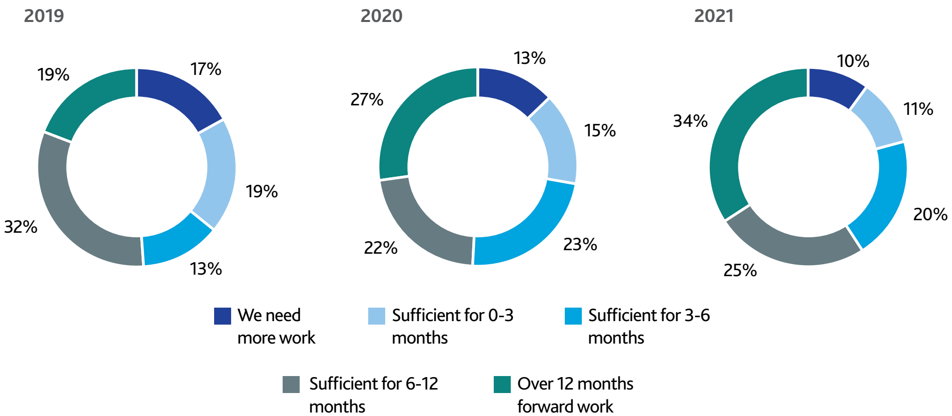
Forward work position

AT A NATIONAL LEVEL, THE THREE YEAR TREND HAS SEEN THE FORWARD WORK POSITION FOR THE MAJORITY OF CONSTRUCTION COMPANIES LOOK INCREASINGLY HEALTHY. HOWEVER, UNCERTAINTY REMAINS AS TO POSSIBLE DELAYS FOR THIS WORK DUE TO LABOUR AND MATERIAL SUPPLY CHALLENGES.

Secured forward work is a critical measure of the future strength or weakness of the construction sector – and the report findings paint a promising picture nationally. Unsurprisingly, over 60% of the larger companies have over 12 months' forward work planned, with little difference between commercial and residential construction.

Note: This report defines forward work in the context of being able to operate at above breakeven for the relevant period. The report findings focused on secured work and excluded opportunities under negotiation or tender, many of which will be secured later.

Forward work position status



Looking across New Zealand, Auckland is in a strong position with 36% of construction companies having over 12 months' profitable forward work and 23% having 6-12 months' forward work. Wellington respondents indicated strength in their region. Companies in the South Island and rest of the North island had an even spread across the sufficient forward work categories.

Not only is the forward work position the strongest since BDO started our surveys, but discussions with larger clients indicate a lot of future work at the negotiation stage. Even if some of this work does not eventuate it suggests that revenue could continue to grow. This is a potential danger signal.

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We're seeing a distinct bi-modal trend develop in relation to sector financial performance and outlook, with the majority of large head contractor firms growing their gross margins, while gross margins decline for many smaller head contractors and the subcontractor category. Should this trend continue for the sector, we risk seeing smaller companies battling each other on low margins in a period of heightened risk which inevitably results in casualties

Nick Innes-Jones
Advisory Partner and Construction Specialist, BDO Auckland

Re*think* required

Organisations need to decide whether they will turn down some forward work - staying at existing activity levels and within the capacity of their staff to manage. Alternatively, by taking on additional projects, they run the risk of being unable to source sufficient staff to successfully manage and perform those projects, resulting in losses.

MANAGING RISK

Risk acceptance and management

The sector has always exhibited high levels of risk, particularly relative to margins and the attempts to transfer risks to other parties is well known.

Management teams have similarly been managing and mitigating these risks for some time.

Common themes from 2021 responses in relation to changes in risk acceptance and management include:

- Greater focus on systems and processes
- Tougher attitude to contract terms
- Increasing prices and margins
- Reducing guarantee terms and periods
- Greater communication to resolve or correctly attribute risks
- Increased management and recruiting to increase senior staff in risk management areas
- Greater selectivity and prequalification of both clients and subcontractors
- Much higher focus on the supply chain and in many cases early purchase of componentry

Retentions

The retentions legislation introduced in 2015 was loosely drafted and our annual surveys have consistently shown about 25% of those that hold retention money do not do so in full accordance with the intent of the legislation or in a separately identified trust account. This is about to change.

The government has introduced a Bill that significantly strengthens the legislation including:

- A requirement to hold the funds in a separately designated trust account
- A penalties regime for non-compliance
- An enhanced reporting regime
- Some clarity and provisions in the event of an insolvency appointment

FOR THE 23% OF THE 2021 SURVEY RESPONDENTS THAT SHOULD BE BUT ARE NOT USING A SEPARATE TRUST ACCOUNT, THEY WILL SHORTLY NEED TO CHANGE THEIR PROCEDURES.

And for the 64% of those who have retentions owing but have never inspected to ensure their retentions are held correctly, they should be inspecting and will have enhanced inspection rights.

Re*think* required

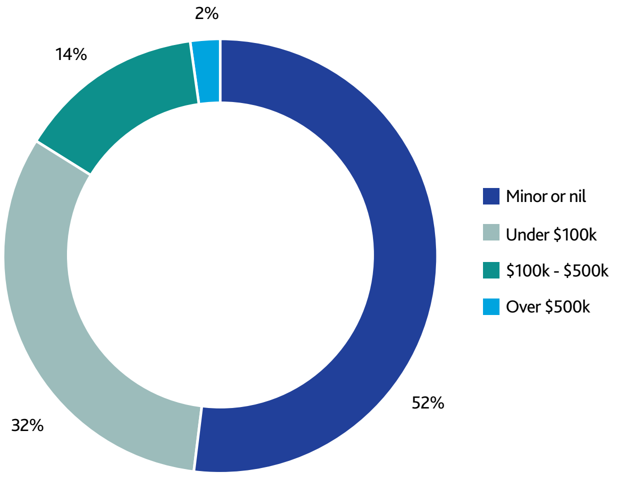
With the current inflationary trends and challenges, is it time for some of the key construction sector risks to be pushed back up the chain towards the client?

Financial loss due to failure of subcontractors or bad debts

Most risks in construction are project related but financial risks should not be overlooked. The graph below depicts the frequency of losses from bad debts or subcontractor failure.

The frequent and significant increases in price for materials and labour rates in the current fixed contract environment are likely to lead to more failures and deterioration of this measure, both in frequency and scale.

Frequency of losses from bad debts or subcontractor failure

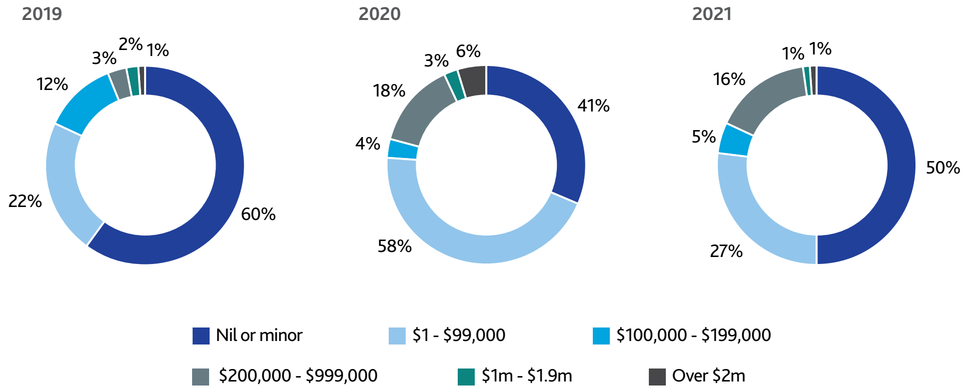


Contract disputes and risks

Construction, more than any other industry, has a reputation for very large disputes and unreasonable behaviour from a small minority. Tight margins and large monetary amounts are a factor in this. Nearly all recent large construction company collapses have been impacted or triggered by a substantial dispute which usually impacts cashflow quite quickly.

Others that have been involved in large disputes have taken several years to recover before dividends or shareholder loan repayments are possible.

Frequency and cost of unreasonable contract disputes



Selectivity of projects and clients is important, as is robust maintenance of project documentation so that risks can be mitigated at each step. Issues do frequently arise on projects but managing them while they are small, assists in preventing them becoming large.

Rethink required

The combined challenges of material delays, inflation and all participants on a project obtaining the staff resources they need, are ingredients that can create a greater number of disputes and losses from them.

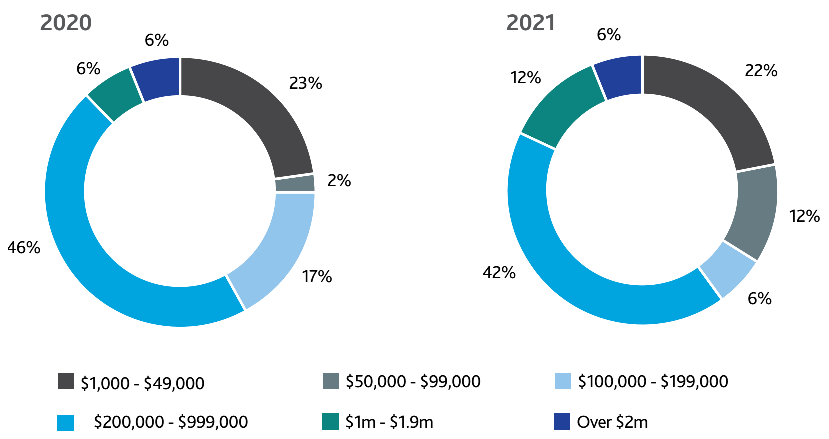
FORTUNATELY, OUR 2021 REPORT HIGHLIGHTS THERE IS A DECREASE IN THE FREQUENCY OF UNREASONABLE TRANSFER OF RISK, BUT THE COSTS OF THOSE SITUATIONS ARE SIMILAR. OVERALL RESULTS FOR 2021 ARE SIMILAR TO PRE-COVID (2019) LEVELS.

Financial loss due to unreasonable transfer of contractual risk

A defining feature between the current and previous construction cycle is the allocation of risk. Clients and their consultants are pushing as much of the risk down to the construction companies as possible, and these businesses, where they are able, try to push the risk further down to the subcontractors.

To determine the extent to which this is a real rather than a perceived problem, we asked the question, "How much do you estimate that unreasonable or inappropriate transfer of contractual risk has cost your business in the last year?". In this year's study, 68% of construction companies (2020 44%) did not identify any cost, and an analysis of the remaining 32% (2020 56%) is shown in the graph below.

Estimated cost of unreasonable or inappropriate transfer of contract risk

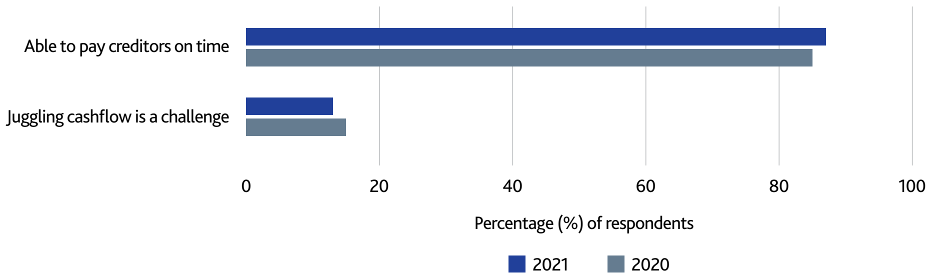


Cash resources

WE'RE SEEING AN OVERALL STABLE PICTURE FOR CASH RESOURCES, WITH NEARLY 90% OF CONSTRUCTION FIRMS CONSISTENTLY ABLE TO PAY CREDITORS ON TIME.

Cash is king in the construction sector, especially in a time of significant disruption caused by COVID-19. Companies with a large cash reserve and strong balance sheet should be more resilient against shocks in the industry.

Status of cash resources

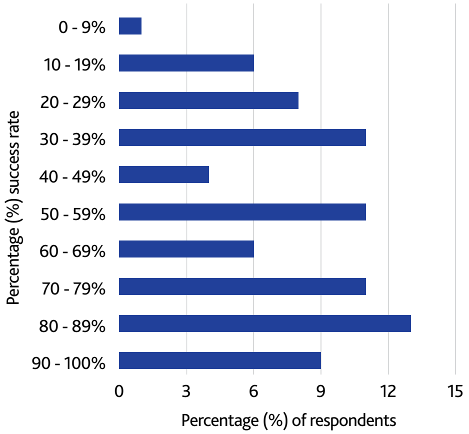


Tender and contract negotiation success rate

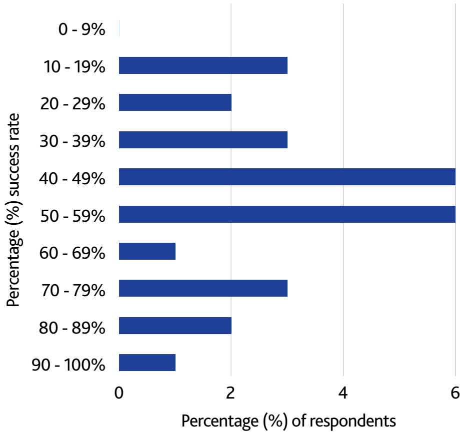
To gain an understanding of the success rate or conversely the wasted time, we asked respondents about the success rate for winning work.

THOSE WITH A LOW SUCCESS RATE ARE BECOMING MORE TEMPTED TO UNDERTAKE 'SUICIDE BIDDING', WHICH REDUCE PRICE AND MARGIN EXPECTATIONS - CONTRIBUTING TO THE "RACE TO THE BOTTOM" AND A WEAKER SECTOR.

Tender and pricing success rates
Head contractors



Tender and pricing success rates
Sub contractors



We're seeing significant resource being input into preparing responses to tender opportunities and pricing work on a negotiated basis. This becomes a significant overhead; often absorbing around 1% of turnover and scarce time resource of senior staff which would otherwise be available for managing contract works. As the industry learns to factor in inflation the time and cost will increase".

James MacQueen

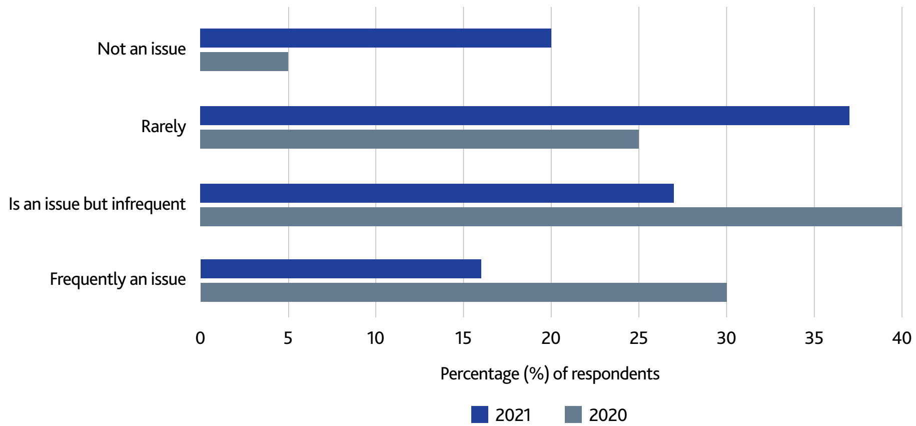
Advisory Partner, Construction and Real Estate Sector National Leader, BDO Auckland

Impartiality of engineers to contracts

The engineer to the contract is a person appointed under the standard form contract: NZS3910: 2013. They are usually appointed by the principal and have two key functions: agent for the principal and an impartial quasi-judicial decision-maker. Because they must act in the best interests of the principal, yet be an impartial administrator of the contract, there is an inherent clash of responsibilities when difficulties arise. This is particularly the case where there is a dispute between the contractor and the principal which is referred to the engineer for his determination.

THERE IS A MARKED IMPROVEMENT IN 2021 HOWEVER THESE RESPONSES STILL INDICATE BOTH THE IMPORTANCE OF CONSTRUCTION COMPANIES BEING HAPPY WITH THE PROPOSED ENGINEER TO THE CONTRACT BEFORE THE CONTRACT IS SIGNED BUT ALSO THE IMPORTANCE TO THE CLIENT THAT A SUITABLE PERSON IS NOMINATED.

How often do you question that impartiality?



REPORT CONTRIBUTORS

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Qualifications

Chartered Accountant (B.Com)
Member of NZIOB
Member of NZ Society of Construction Law

Executive Summary

With more than 40 years of advisory, business services, tax, corporate finance and audit experience, James maintains a proactive partnership approach with his clients who benefit from his multi-disciplinary range of services and experience across a wide range of industries.

James passions include construction, succession planning and family business. He has great insight into the issues and challenges facing the sector. James develops a very close relationship with his clients and provides practical and pragmatic advice on a wide range of matters.

His clients appreciate his strong industry expertise and look to him for leadership in emerging issues.

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Qualifications

Chartered Accountant (B.Com, LLB)

Executive Summary

Nick has more than 16 years' business services, corporate finance, business recovery and restructuring and commercial experience in New Zealand and overseas.

He works with a range of clients in a wide variety of businesses, including property, construction & family businesses. Nick is involved with corporate finance transactions, valuations and general business advisory work.

Nick worked for BHP Billiton, the largest company in Australasia in various finance roles for three and a half years working in London, Johannesburg, Melbourne and Brisbane before settling in Sydney with the company. He returned to Auckland in 2013, joining BDO to focus on construction, business advisory and corporate finance.

HUSAIN SUTERWALA

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Qualifications

Chartered Accountant (B.Com)

Executive Summary

Husain is an Advisory Senior Manager in the Construction team where he works closely with James and Nick. He has client service responsibilities for many of the more complex construction groups and is frequently the first point of contact for a wide range of issues raised by clients or which they need assistance with.

He has a strong understanding of the IFRS Financial statement issues impacting construction companies, the tax issues which are particular to the industry and the construction specific software packages commonly used. He assists with many of the succession plans, valuations and banking negotiations which arise. Clients appreciate his direct and comprehensive advice on a wide variety of issues for both head-contractors and sub-contractors as well as developers.

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To connect with our national construction sector team, scan the QR Code below or visit bdo.nz/construction


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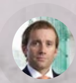
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