

Building Knowledge

The short-term future of the E&C sector is public news

Back in January 2009, we reported that the overall outlook for the Engineering and Construction (“E&C”) sector would be mixed though fare better than many other industry sectors in the Asia Pacific region. Since then there have been a number of mixed messages across the industry. Whereas there are clearly opportunities in the coming few years, especially in the government sectors, a number of risks remain. We highlight a number of these risks in this flyer.

Lastly, we conclude with a brief overview of the China Greentech Initiative (“CGTI”), a project with the American Chamber of Commerce in Shanghai and PricewaterhouseCoopers as Founding Partners. As sustainability and climate change are becoming increasingly important issues both in the E&C sector and throughout the broader economy, this initiative brings together over 80 of the world’s leading green technology companies, united in a single purpose to uncover, create and promote greentech opportunities in China.



The markets

Hong Kong and Macau private sector remains mixed

In our January flyer we noted that corporate spending in the region, especially in Macau, has seen rapid declines that were likely to take some time to recover due to reduced market liquidity. Since then the construction at parcels 5 & 6 of the Venetian on the Cotai Strip are in the throes of project termination uncertainty and the new HK\$4.8 billion air cargo terminal at Chek Lap Kok continues to be delayed. While the volume of cargo exports declined by approximately 13% year on year, imports and transshipments also declined, with volumes still well short of those when the announcement of the terminal was made in March 2008.

However, recent reports have indicated that the Las Vegas Sands Corp. has secured short-term funding of US\$600 million and are considering to sell shares in its Macau business. The funds raised are expected to be used to reduce debt and to complete terminated projects.

Whereas it may be some time before the Las Vegas Sands' Macau projects are completed, it is an indication of an improved liquidity in the markets on the back of a rebound in the Las Vegas Sands Corp share prices since March 2009.

Notwithstanding the increased propensity to lend by regional financial institutions, with many corporates focusing on improving balance sheets, large scale private construction is expected to remain weaker than government spend in the coming years in the region.



Overview of regional public projects

With a budget for capital works expenditure of HK\$39 billion (2008/09: HK\$23 billion), it is one of the HK government's strategies to promote economic growth through infrastructure development. Some of the recent civil projects include the Tamar Development Project for around HK\$5 billion and the ongoing Central reclamation project.

However, the upcoming projects are larger in scale and are road and rail oriented. The South Island Line, Shatin to Central, Kwun Tong Extension and the Express Rail Link railway projects have a capital cost of more than HK\$80 billion alone. The HKSAR government investments in the Tuen Mun Bypass and Hong Kong Macau Bridge are expected to be well over HK\$60 billion and urban renewal projects for Kai Tak and West Kowloon are also expected to be in excess of HK\$40 billion albeit consisting of smaller constituent parts.



In comparison to historical government annual investment spend, the increase in the Hong Kong government's investment budget is significant over the coming years. But some of the projects are also larger than many that have been undertaken previously, leading the government to consider the exposure to single contractors, leading to perceived benefits in accepting tenders from joint ventures. Both the Tamar Development Project and Central reclamation project are contracted to joint ventures.

Opportunities also bring operational challenges

As a result of the stimulus packages in Hong Kong and mainland China having a particular focus on massive infrastructure projects, the civil and public sectors are expected to be buoyant in the coming years.

The significant opportunities to both large and small market participants arising from government spending on capital works is far from devoid of risk. Whereas some can be attributed to the larger contractors, such as joint venturing and sub-contractor non-performance, many of these risks will effect the entire sector and be heightened due to external market factors. We consider that the main challenges relate to cash flow and balance sheet forecasting, staff resourcing as well as dispute resolution and recovery of claims and variation orders.



Joint venturing

Owing to the size of civil projects in the pipeline, the number of joint ventures is expected to increase. The benefits to government is that the joint venture is supported by two qualified contractors to offer a single product. The contractors benefit from leveraging expertise and sharing of resources for the benefit of the project.

However, there are also operational and financial risks that should be considered:

- Regular and clear communication between the venturing parties is paramount, especially in financial reporting and funding-related matters.
- Partners from different cultures often have varying styles and expectations that could lead to internal misunderstanding and a loss of credibility with the employer. To that end, convergent goals are key.
- Decision making could be slower than own projects due to duplication of approvals.
- Process for dispute resolution.

Your people must remain on the agenda

The government statistics have recently shown unemployment in the industry above the Hong Kong average though concerns still remain over the need for imported labour as the technical aspects of the major projects may require international experience. To that end, unemployment may not fall in relation to the new projects.

Notwithstanding this, the retention and training of quality staff at all levels is fundamental to the performance of the business. Identifying key talent and ensuring appropriate incentives are in place to retain and motivate staff as well as identifying key relationship owners with both customers and subcontractor is key to continuing to deliver value and service.

Cash flow forecasting and balance sheet management

Cash flow forecasting has never been easy for engineering and construction businesses. The future revenue stream is highly dependent on macro economic changes and public spending policy. The volatility of material costs has added more challenges in projecting the future cash flow. Adopting the leading practices in forecasting allows companies to gain better visibility of future cash flow and to improve financial planning.

In addition, the efficient use of cash is an important business performance indicator. However, cash is sometimes left idle or tied up in working capital and operational processes. Proactively managing the balance sheet can release cash to support financial and operational initiatives, which is particularly important at a time when credit is tight.

Subcontractor non-performance risk

Non-performance of subcontractors continues to be a key operational risk. It remains such as, although the key market indicators lead to an improvement in liquidity, this has yet to fully flow into those unlisted and smaller businesses.

It will take time for full recovery and while the markets do improve, lenders will continue to carefully scrutinise the risk of their loans and will seek to protect their interest if it is seen to be threatened by breaching of covenants. Whether covenants of the Company or a sub-contractor, this clearly will have financial and operational implications.

Revisiting procedures over appointment and continuous assessment of subcontractors will help to mitigate the potential financial and reputational damage arising from any non-performance. Also, regular discourse with subcontractors will help in identifying any underlying financial problems.

Dispute resolution and recovery of variations

Dispute resolution is not new in the industry with negotiations over claims, liquidated damages and variation orders being common-place. However, with the termination of various Macau projects followed by employee retrenchments, it can be seen that continuity of staff (on both sides of the table) as well as ordered retention of key project documents is key to minimising the risk of protracted negotiations. At a time when “cash is king”, delays in the payment and release of retentions and bonds awaiting final accounts have a significant impact on cash flow, which will have an impact on refinancing negotiations as well as the terms given by lenders on future credit facilities.

As is generally seen in all major projects, variations and claims are expected to be a growing area of focus as the HKSAR government move through their investment programmes on the main infrastructure projects. Now is a good time to revisit the controls over this area, before commencement of projects.

Green initiatives are also abundant in the market

Policymakers and market participants are increasingly focusing on the importance of sustainability, driving growing opportunities related to green technologies. As demonstrated by the government-led Tamar project in Hong Kong, energy efficiency, in particular, is a key government focus in Asia.

The China Greentech Report 2009 produced by the CGTI provides a cross-sector analysis of China's greentech market and environmental issues, covering the cleaner conventional energy, renewable energy, electric power infrastructure, green building, cleaner transportation, cleaner industry, and clean water sectors. The renewable energy, transportation, and green building sections of the report address specific E&C-relevant greentech solutions such as renewable power plant construction, integrated design, sustainable materials, and public transportation infrastructure planning and development among other solutions.

In addition to solution assessments, the report contains analysis of the market and environmental issues driving China's greentech market growth, information on China's regulatory response, key greentech market development challenges, and clear opportunities for stakeholders to accelerate greentech markets to create an environmentally sustainable China.

The China Greentech Report 2009 Executive Summary is available free-of-charge and can be downloaded from <http://www.pwchk.com>.

Summary

Although it is clear that the outlook for engineering and construction in the civil section is favourable due to the pipeline of mega infrastructure projects, there are significant risks arising from the macro-economic and local environment which need to be carefully managed.

Address bubbling problems before it is too late!

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