Construction Industry Distressed Asset Workout: whitepaper

Auxilium Partners and Cathro Partners in conjunction with Kingfisher Venture Management 2022
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"Distress in construction and some practical tips that construction businesses might take in situations when they are staring down a financial distress situation".

Construction industry stress

This article aims to outline to the readers how the proper management of situations whereby construction businesses, developers or related parties operating in a distressed environment can minimise the fallout of increasing costs and project delays and look to 'work-out' of the problem if a fast and effective manner that preserves or protects value for impacted stakeholders.

The drivers of increasing stress in the industry are many – extended and unpredictable severe weather patterns, supply chain shortages, labour shortages and rising energy costs are among them. Compounded by historically structured fixed-price contracts that typically favour the developer, there is a recent push to seek to share this risk in newly entered contracts or revisit the rigidity and terms of historically agreed contracts that seek to provide some relief to builders.

With many construction companies committed to projects that are no longer financially viable for the reasons stated above, there is currently a shift in the mindset of parties operating in a distressed environment to try to work together to keep the builder operating and increase the chances of project completion with least impact on value. This outcome is not always possible and distressed asset or project workout strategies are required.

Insolvencies up 28% year on year

Rising costs and ongoing supply chain issues are the biggest issues putting pressure on sole traders and small business owners in the construction sector and are a prime contributor to recent 2.5% + rises in inflation.

The quarterly commercial insights report by Equifax, which measures the volume of credit applications filed through Equifax Commercial Bureau by financial services credit providers in Australia, shows insolvencies in the construction sector 28% higher in March 2022, compared to

March 2021.

In the March 2022 quarter, 270 construction companies filed for insolvency, up 21% year- on-year. Rising costs, disrupted supply chains and periodic lockdowns have created a 'profitless boom' for many construction businesses.

How to approach construction businesses and situations in financial or other areas of distress?

The theoretical (and typically pragmatic) project management triangle is a model of the time, ***cost*** and ***quality*** constraints of a project. It contends that:

· The quality of work is constrained by the project's budget, deadlines and scope (features).

· The project manager can trade between constraints.

· Changes in one constraint necessitate changes in others to compensate or quality will suffer.

In an environment where there exist no external pressures, you can typically prioritise and pick two constraints - "Good, fast, cheap. Choose two." In practice and particularly in distressed environments, this prioritisation is hampered and trading between constraints is not always possible.

For example, throwing money (and people) at a fully staffed project can slow it down. Moreover, in distressed or poorly run projects it is often impossible to improve budget, programme or scope without adversely affecting quality.

Furthermore, in a distressed environment whereby project design is often complete and locked in by conditions of a consent authority and the commercial objectives of the developer, the constraint of quality cannot shift – leaving us with the 'time' and 'cost' levers of the model to focus and negotiate on.

Working through distress and dispute

The starting point for businesses or projects in a distressed situation is an independent audit and workshopping with key stakeholders. This can include:

· A quality review to check code and design compliance against works completed onsite

· Forensic review of the historic and forecast cost reporting and protocols to establish the cost to complete estimates

· Technical review of the construction programme and likely recasting of that programme, including a possible revisit of the critical path and procurement tasks. We consider any supply chain or other delays against supply and labour constraints to establish a time to complete estimates

· Review, update and prioritise the project risk register against all current issues

· Interview and workshop with the developer and builder's delivery team to establish a documented recovery plan and delivery finalisation strategy

Managing risks in a distressed environment

It is in the interests of both principals and contractors to ensure that the risk of supply chain delays and materials shortages are appropriately managed. For principals, the main causation of distress is exposure to cost overrun, delays to practical completion and the solvency of the contractor. For contractors, the main risks are again exposure to increased construction costs and liability for liquidated damages for delayed practical completion.

Supply chain consultancies around the country are forecasting global shipping will level out in

2023, however, related issues are expected to linger for the next 12 months. The same follows for escalation of building materials whereby we have seen increases of between 15-30% for some materials, with the year ahead expected to ease into a 5% BPI average.

To manage this market volatility in a general sense, it is important that project requirements are well documented in a robust design brief that clearly defines the project scope at the very initial concept stage, and that this flows through to a tight contract instrument with known objectives. This solidifies project and construction requirements to minimise the risks associated with cost escalation, variations, and resultant delays. If caught at the early design phase, developers can optimise design or pivot to cheaper alternative materials to minimise the risk of cost increases during project delivery and develop a construction programme that accommodates longer lead times for construction materials.

In a distressed environment and in the first principles of project establishment, there are a number of ways that parties can seek to manage the risks of supply chain delays and materials shortages through contractual mechanisms. These include:

Order building materials early

In a distressed environment whereby building materials may be more susceptible to being affected by supply chain delays or shortages leading to price increases, it may be worthwhile for the principal of the contract to make an early payment to the contractor for the relevant materials so that they can be ordered in advance.

The principal typically requires the contractor to provide it with security (e.g., a bank guarantee) for an amount equal to the early payment, however, in a distressed environment whereby facilities may be stretched, negotiation outside of the contract for offsite and general payment protocols is something to be considered. This may be negotiated between parties with the assistance of the financier and their approved quantity surveyor.

A similar arrangement follows for long-lead items. Where such an arrangement is extended beyond traditional long-lead items, early than usual ordering may assist in ensuring that materials are received within the required time and will also provide a level of price certainty. The simultaneous provision of a bank guarantee (or as agreed outside of the contract) to the principal will serve as protection for the principal should the contractor become insolvent prior to the materials being incorporated into the relevant works.

Consider alternative or substitute materials

We have touched upon the issues of quality often being 'locked in' above, however, if the design and construction nature of a contract or the contract has not yet been agreed upon (if there is a transition of builders) then alternative materials can be considered.

If parties identify that certain materials selected may be difficult to obtain or subject to price fluctuations, it may be beneficial to thoroughly consider if those materials could be substituted. If there are suitable options that are subject to less supply chain risk and price risk, parties could substitute materials or make provision for several alternatives to be used depending on future market conditions.

In a distressed environment, it becomes important to carefully identify, negotiate, agree then document the alternatives or substitutes into the contract (as a variation without cost or otherwise).

Include or negotiate supply chain provisions in the contract

Supply chain risk has traditionally been allocated to the contractor to manage. In some circumstances, these uncertain times may require that this risk is more appropriately shared between the parties.

In the event that a project or situation becomes distressed, this may require a degree of flexibility in the application of the delay provisions of the contract in the form of the grating of extensions of time right for the contractor (without cost). It flows from this that the construction programme may also need to be recast and agreed to capture the delays and also to discuss how the application of liquidated damages will or will not be handled – we suggest an open and early dialogue between parties to remove lingering doubt on the application of damages for the residual programme duration.

Where such an extension of time right is being contemplated, the principal will want to ensure the distressed workout process ensures strict parameters are put in place so that

the contract concession is not open-ended and only applies where the supply chain delay is affecting all contractors working on similar projects.

Consideration of the rise and fall for specified materials

While it will usually be the principal's (and their financier's) strong preference to have a fixed-price / lump sum contract, where there is uncertainty as to the cost of building materials, contractors are likely to build in a cost buffer/contingency to protect themselves against future price escalation.

For contracts historically entered into whereby an insufficient cost buffer has been built in, and the builder is under financial stress as a result of these increases, there may be some benefit for the principal in providing some equitable relief on cost in the form of contract variation (without margin) or alternate contract cost mechanism.

In a distressed environment whereby a transition of builder transpires, the new contract may require specific materials to be subject to some degree of the rise and fall (by way of, say, a 'cap and collar') so that the principal avoids paying too much of a premium for its fixed-price contract.

The unexpected delays and price increases associated with supply chain issues and materials shortages are some of the most common risks currently facing the construction industry. These consequences could make or break a project. It is therefore essential that parties proceed with caution, consider the risks that may arise and clearly allocate those risks before committing to a project.

Top tips for managing construction disputes in a distressed environment:

Be realistic about cost increases

At project conception, the procurement stage is a vital opportunity to take proactive steps that minimise issues and distress later on in the project. In a distressed environment, however, pivoting out of, or changing course on buying decisions is hampered. A key concern here is traditional contract risk allocation, which typically emphasises a lump sum price where risk is borne by the contractor. This can result in contractors bringing claims to make up the difference between the lump sum price and actual (often expended) costs.

For new projects in the currently volatile construction environment, parties should be careful to negotiate realistic contract price overruns with appropriate cost and supply chain flexibility mechanisms considered/imputed. Whereby historic lump sum contracts are placed in significant distress, a workout team is often called into audit and then mediate an outcome. There is often a need for a cost to complete an audit, with likely increases in the lump sum/variation amounts, delays to practical completion dates, and a need for visibility on suitable time and cost contingencies.

Being accurate and realistic about these forecasts mitigates or limits further frustration for all parties, and seeks to create a culture of open, constructive communication around

costs and claims. Both parties should be provided full visibility on the process by an independent advisor (on the workout team) for how costs for each side might be shifting throughout the process, rather than being confronted with a large financial gap upon project completion.

Engage the delivery team in the workout process

There is often a disconnect, in both understanding and communication, between the distressed asset or project workout team, and the project delivery team (builders' site and administration team). It is therefore critical to leverage and builds open the inherent knowledge of the builder to ensure any alternatives in materials, alternate suppliers, optimal changes to the construction programme sequencing etc are fully understood and considered – essentially creating a collaborative approach to the workout solutions.

It is also imperative that the appointed workout team clearly defines roles, responsibilities and communications protocols such that information flow is fast and effective, and also so parties do not operate in 'silos' or on conflicting workout strategies and solutions.

Address specific risks in the workout process

There will typically be a project risk register that is somewhat fluid in nature over the project duration, with items falling off the list as they are dealt with, or entering the list as identified. Often is the case in a distressed environment that problems become wide, varied and numerous and the administration of documenting risk falls away.

As such, an important step for all parties in a distressed environment is to allow the workout team full visibility of all key risks (builder and principal) – with the audit most efficiently carried out forensically by looking through the project documentation, and also through interviews or whole-of-project working sessions focused on risk identification, documentation and prioritisation.

If a distressed situation is to be worked out in a manner that seeks to maintain builder continuity (not change builders), then it is incumbent upon all market participants to engage early, creatively, and transparently when addressing risk – including considering alternate project delivery programmes and completion strategies under a team approach. By being more proactive and collaborative throughout the workout negotiation will likely see all parties better equipped to avoid or minimise the potentially exorbitant costs of protracted project disputes.

Head contractor termination or transition – is this the only option?

It is highly desirable to maintain the incumbent builder on the delivery team if possible, and if parties are able to, and welcoming of a collaborative workout process for mutual

benefit. Often the distress to date and/or builder solvency position does not allow this. In most cases, however, it is unlikely that a transition of the builder will result in aggregate cost or time savings, therefore developers must keep an open mind with regard to sharing all forms of risk.

In the event the distressed situation calls for termination of the builder/contract, it is imperative for on selling of the contract that a full audit on the cost to complete, programme, supply chain and general risk items, payment terms, existing defects, design closeout requirements, warranty and security expectations etc. is fully documented for the incoming builder to carry out their due diligence.

If the builder has full visibility of risk, can price accordingly, and a formal contract agreement can be agreed upon expeditiously, the builder can commence work without excess further delay which will benefit the developer and financier. Pre-selection of suitable builders by the workout team, with some visibility on the builder capacity and capability, will assist the process.

How can Auxilium and Cathro Partners assist?

As chartered accountants with long experience managing distressed asset work-outs, insolvency projects and restructuring companies we create and preserve business value. With a reputation for delivering high-quality results, we guide your business to overcome strategic and financial challenges. We work with business owner/s firstly to explore options and engage consultants if required. Kingfisher Venture Management is a highly personalised project delivery consultancy.

This article was written with Sean Malone, Managing Director of Kingfisher Venture Management. He has led the delivery of over $2BN worth of mixed-use, commercial, hospitality, residential and accommodation projects.

Contact us now for a no obligation discussion

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