

2018 Middle East Capital Projects and Infrastructure Survey

An industry under pressure to reform



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Methodology



We surveyed respondents from across the Middle East region including project owners, developers, contractors, external advisors and financiers, all with a key role in delivering the region's mega projects.

We asked the respondents about the challenges they are facing delivering these projects, their key priorities and the outlook for the year ahead. We conducted our survey during December 2017 – January 2018.



Foreword

I am pleased to report the results of PwC Middle East's 2018 Capital Projects and Infrastructure Survey - *'An industry under pressure to reform'*.

Since we conducted our last survey in 2016, we have seen oil prices recover slightly, opening at the start of 2018 at its highest level since 2014. Despite this, governments and industry continue to face challenges and pressure to perform and deliver "more for less". Without continuous change and improvement to the way projects are procured, financed and delivered it will be increasingly difficult for clients and the supply chain to extract value from these contracts in a sustainable manner.

Stress on contract prices, working capital and cashflow have hurt many regional and international players who operate in the Middle East, and in some cases the consequences have been very serious. What this tells us is that the industry needs to evolve. This can be done through the entry of new competitors, new technologies or changes to regulation to facilitate the delivery of capex programmes. The capital projects and infrastructure market has often been singled out as being ripe for "disruption" due to its resource and capital intensive nature.

The industry is taking steps in the right direction with increased focus on collaboration and innovation. We have seen this in Dubai where BIM (a building information modelling software) is mandated on government projects, providing a platform for collaboration and efficient working from the inception of a project through to operation and maintenance.

In the Kingdom of Saudi Arabia, the National Transformation Plan is very much focused on the delivery of both social and economic infrastructure. This infrastructure will be the building blocks upon which Saudi society will modernise and move forward with renewed confidence and purpose. At the heart of this regional transformation is a clear need to understand the respective roles of government and the private sector. The political will to drive forward the Public Private Partnership (PPP) agenda and private financing is very clear to see with Oman, the UAE, Qatar, KSA and Kuwait all establishing institutional frameworks to facilitate the use of long term private financing to underpin a large proportion of capital projects.

Our bi-annual survey captures the industry's sentiments and views on a wide range of pertinent issues and topics. I would like to take this opportunity to thank everyone who contributed. Your views are essential to us and I hope that over time our collective thinking will be able to influence regional policies and business practices.

I hope you enjoy the findings of our report.

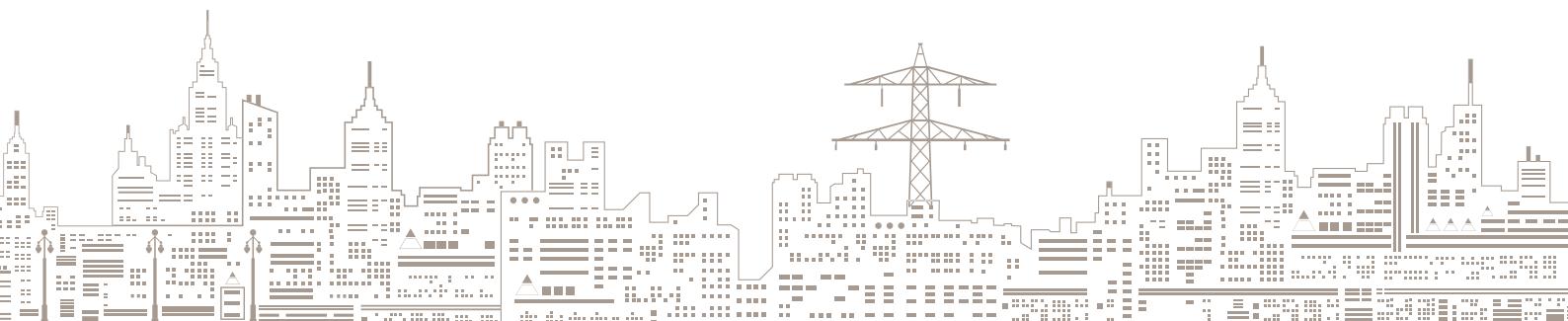


Maarten Wolfs

Middle East Deals – Infrastructure & Government Leader

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Executive Summary

The findings of our fourth Middle East Capital Projects and Infrastructure survey suggest there is an increased need for governments to continue to deliver both social and economic infrastructure projects across the Region.

In the following sections, we outline the current challenges facing the industry and highlight the importance alternative financing will have on future investment projects. Our key highlights include:

Capital expenditure

- 49% of respondents expect spending to increase over the next 12 months. An upward trend but still far from 2014 spending levels
- There is a more positive outlook with only 19% of 2018 respondents seeing a marginal decrease in their capital expenditure compared to 63% in 2016

Project performance

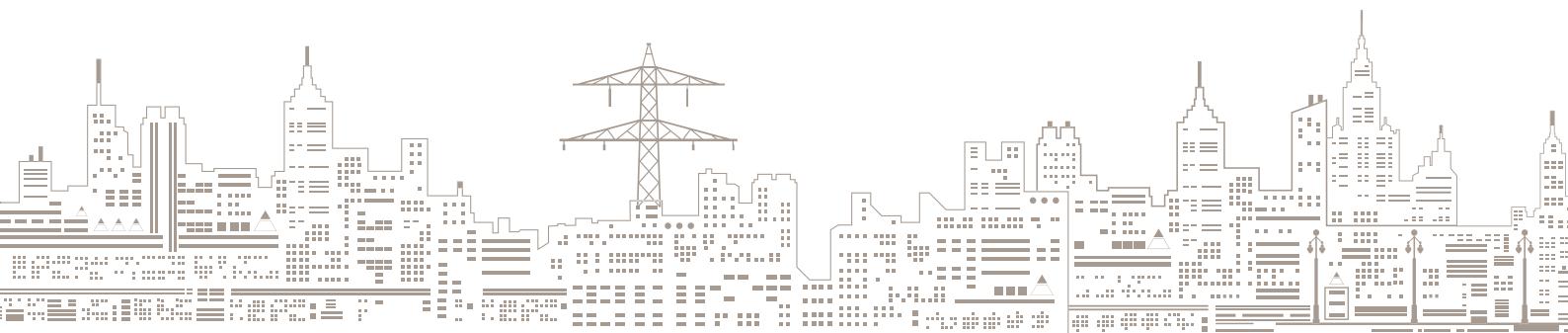
- Overall, project time performance has improved with 34% of respondents indicating that projects are more than 6 months delayed compared to 47% in 2016
- 36% of contractors surveyed have reported a decrease in profits, primarily driven by increased cost of materials, labour and equipment, along with challenges relating to working capital

Building in-house capabilities

- Owners are developing their in-house project management capability and strengthening their governance and controls

Private sector financing

- 49% of respondents believe that in the short term, there will be a mixture of private and government funding over the next 12 months
- 80% of respondents believe that over the longer term private sector funding will continue to increase



Industry outlook and challenges

Optimism regarding capital expenditure

Optimism among executives in relation to spending on capital projects in the Middle East is on the rebound. Our survey highlights that some 49% of respondents expect spending to increase over the next 12 months, with one in six expecting an increase of 25% or more. In contrast to our 2016 survey, only 21% thought spending would increase. Among C-Suite executives optimism is stronger with 29% expecting spending to rise by at least 25% this year.

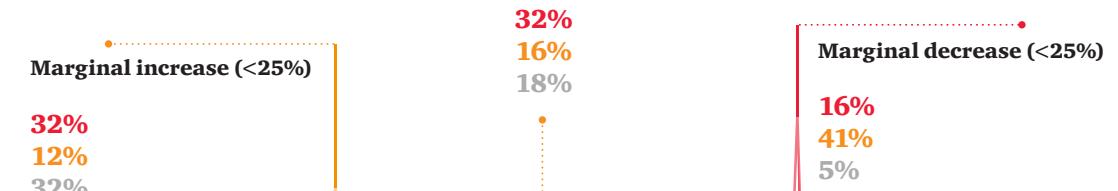
However, despite the improving backdrop, our survey finds that the industry is facing major challenges on all sides which must be addressed if it is to make the most of any growing readiness to spend.

We are seeing upward trends with regards to increases in expenditure, with almost half our respondents spending more, but still far off the sentiment of 2014

Q. In your opinion, what is the outlook for your industry for the next 12 months?

Base: 108

Remain largely the same



Significant increase (>25%)

17%
9%
43%

Marginal increase (<25%)

32%
12%
32%

32%
16%
18%

Marginal decrease (<25%)

16%
41%
5%

Significant decrease (>25%)

3%
22%
2%



■ 2018 ■ 2016 ■ 2014

Project performance

There is already some evidence that project performance may be improving. Our survey found that over the past year the proportion of projects delayed by 1-6 months had fallen by 9 percentage points, and delays of more than six months were down 13 percentage points.

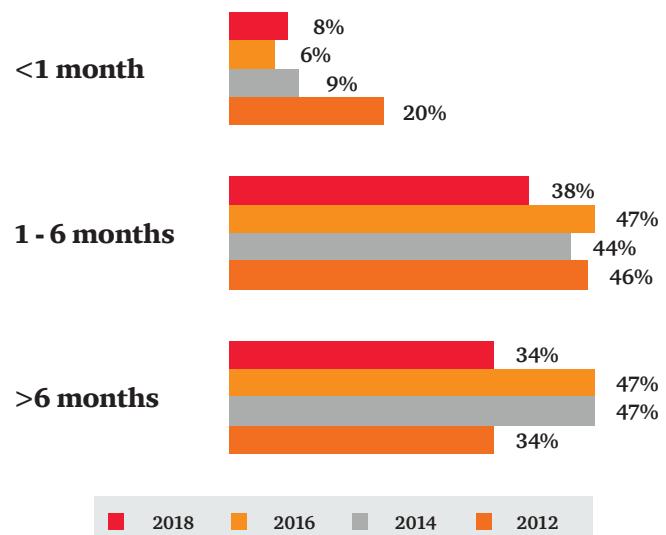
“Scope changes” are the primary reason behind delays and are most likely to average between 1 - 6 months

The main reason for delays and cost overruns remains a constant challenge with capital projects across the region: changes to the scope of projects already started.

With that said, there may be some grounds for optimism in this finding. The proportion of respondents citing poorly defined scope or inadequate design as a major cause of cost overruns fell from 60% in 2016 to 46% in 2018. Welcome though, this hint of progress may be the persistent problem of scope which emphasises the urgent need to improve the skills of those commissioning major capital projects. Poor and inconsistent procurement practices at national and municipal levels also contribute to cost overruns and contract variations. PPP-style competitive tendering (both capex and opex) underpinned with long term fixed pricing needs to become more prevalent before governments start to control spiraling costs and manage delivery risk.

Q. On average, to what extent have projects in your portfolio experienced delays in the past 12 months?

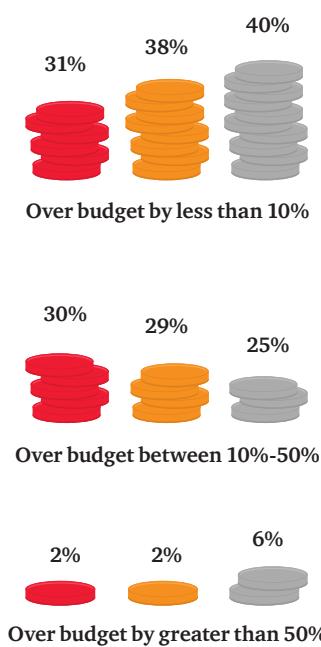
Base: 91



2018 - No delays (10%), No visibility of schedule (10%)

Q. On average, to what extent have your projects experienced costs variances in the past 12 months?

Base: 88



Industry outlook and challenges

Priorities for improvement

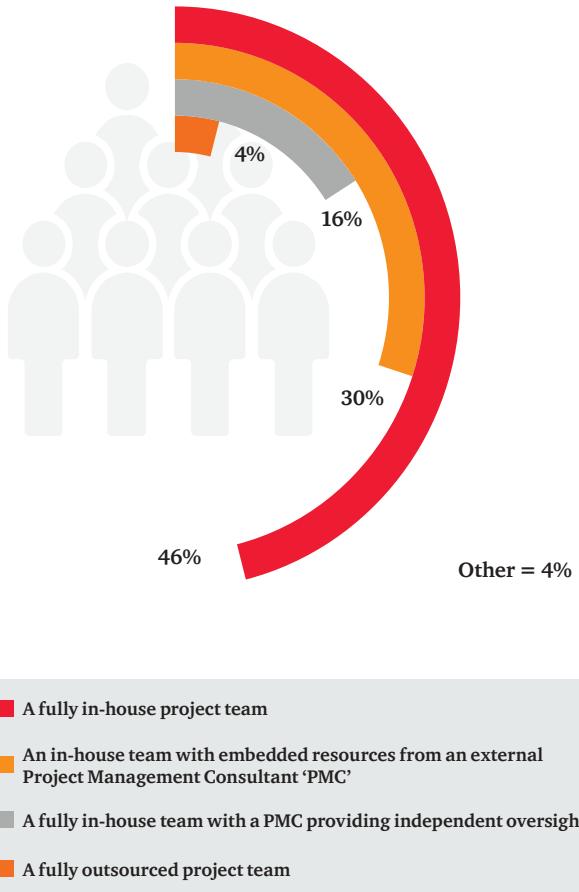
Our survey shows that there are changes in the way major infrastructure projects in the Middle East are managed. Currently, project management is fully outsourced to consultants on about 80%-90% of projects, but clients are signalling that this is set to reverse with 46% of all respondents saying a fully in-house Project Oversight Team was the most effective way to deliver projects. However, within the subset of contractors, 79% indicated that this was the best way to deliver projects. This finding suggests a turn in the industry cycle: clients are now signaling that they are unhappy with outcomes from outsourced project management.

The second major priority for change is improving the accuracy of budgeting and forecasting. Middle Eastern capital projects have been beset in the past by poor and over-optimistic projections, but as pressure on public spending increases, the extent to which problems in these areas can destroy value is becoming clear.

Finally, respondents in 2018 signaled an interest in investing in technology to increase efficiency. This is encouraging but it remains a minority concern in an industry that lags far behind others in its tech spending, largely because low-cost labour presents a cheaper option than investing upfront for longer-term productivity gains.

Q. Which partnering model do you consider to be most effective in delivering your projects?

Base: 79



“

46% of all respondents said a fully in-house Project Oversight Team was the most effective way to deliver projects

”

Contractors: unrelenting pressure on margins and profitability

Q. When thinking about your profit margins over the last 18 months, please indicate if they have increased, decreased or remained consistent?

Base: 95



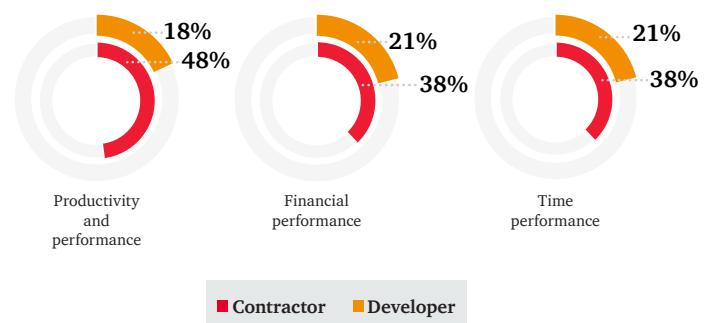
Among construction contractors, the slowdown in spending throughout 2017 has caused increased pressure on an industry that was already thinly capitalised. The squeeze on funding for capital projects from the top down has rippled through the construction supply chain: by far the biggest external challenge facing contractors in 2018 was payment delays by clients, with availability of funding coming second. Client decision making in areas such as scope changes was third at 33%.

Pressure on margins is widespread, particularly as a result of cost inflation for labour, materials and equipment, although almost 30% of respondents say their margins have improved over the past year. This may indicate a divergence where better performing contractors have been able to benefit from failed rivals leaving the market, while others that are more leveraged, particularly smaller organisations, have seen their margins shrink, 36%.

As they seek to tackle these pressures, 48% of contractors are focusing on efforts to improve productivity and performance, which is by far the most important internal challenge they face, this is followed by the need to improve time and financial performance. The ability to invest in initiatives that would lift productivity is limited, particularly among smaller operators. In 2017, this was exacerbated as a result of a decrease in the volume of advance payments due to fewer projects being commissioned. These payments are critical for working capital and this reduction has added to financial pressures on contractors.

Q. What are your top 3 internal challenges in relations to the projects you are involved in?

Base: Developer - 31 / Contractor - 21



Increased costs and late payments

For their part, contractors are being subjected to financial pressure by late payments along with increasing cost pressures. A number of prominent players have fallen into financial distress recently and access to funding for working capital remains a challenge. Among smaller operators especially, margins have deteriorated, making their position more challenging.

Delayed payments from clients is a huge issue for over half of contractors surveyed and more than three times as much as developers

Industry outlook and challenges

More robust project governance is needed to improve outcomes

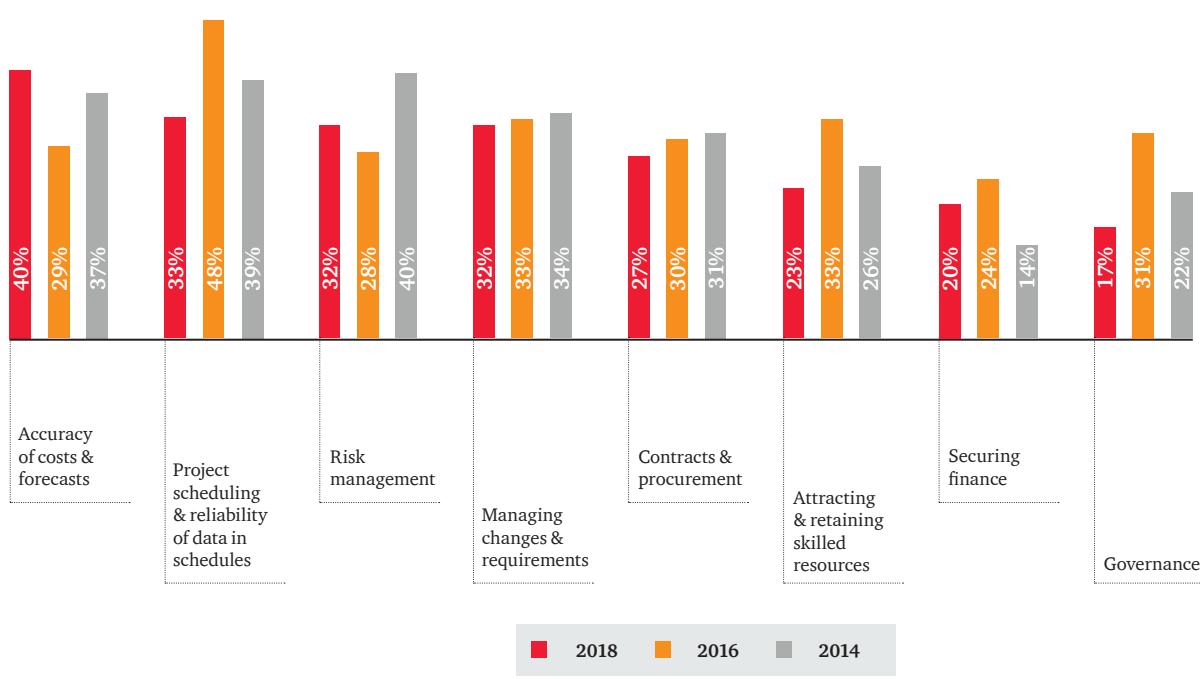
Governments across the Middle East face a critical challenge: to maintain their growth momentum during a period of unavoidable fiscal contraction. Capital projects through the development of national infrastructure can play a central role in enabling long-term economic development. Failure by governments to invest will inevitably put long-term growth targets at risk. But to finance their projects, governments will need to tackle two key priorities: spending the available funding as efficiently and effectively as possible, while attracting additional capital and private finance through the debt and capital markets.

Respondents to our survey say that greater focus on improvements in project planning, governance and risk management will be key to achieving more efficient public spending on infrastructure. Among developers, the most frequently cited internal challenges were risk management, governance, and organisational capability, indicating that at boardroom level, the historical tolerance for poor budgeting, poor procurement practices and forecasting may be at an end.

On projects where costs overran, over-optimism on budgets and contingency reserves were cited as the cause, 37% in 2018 against 27% in 2016.

Q. What are your top 3 improvement priorities in relation to your projects?

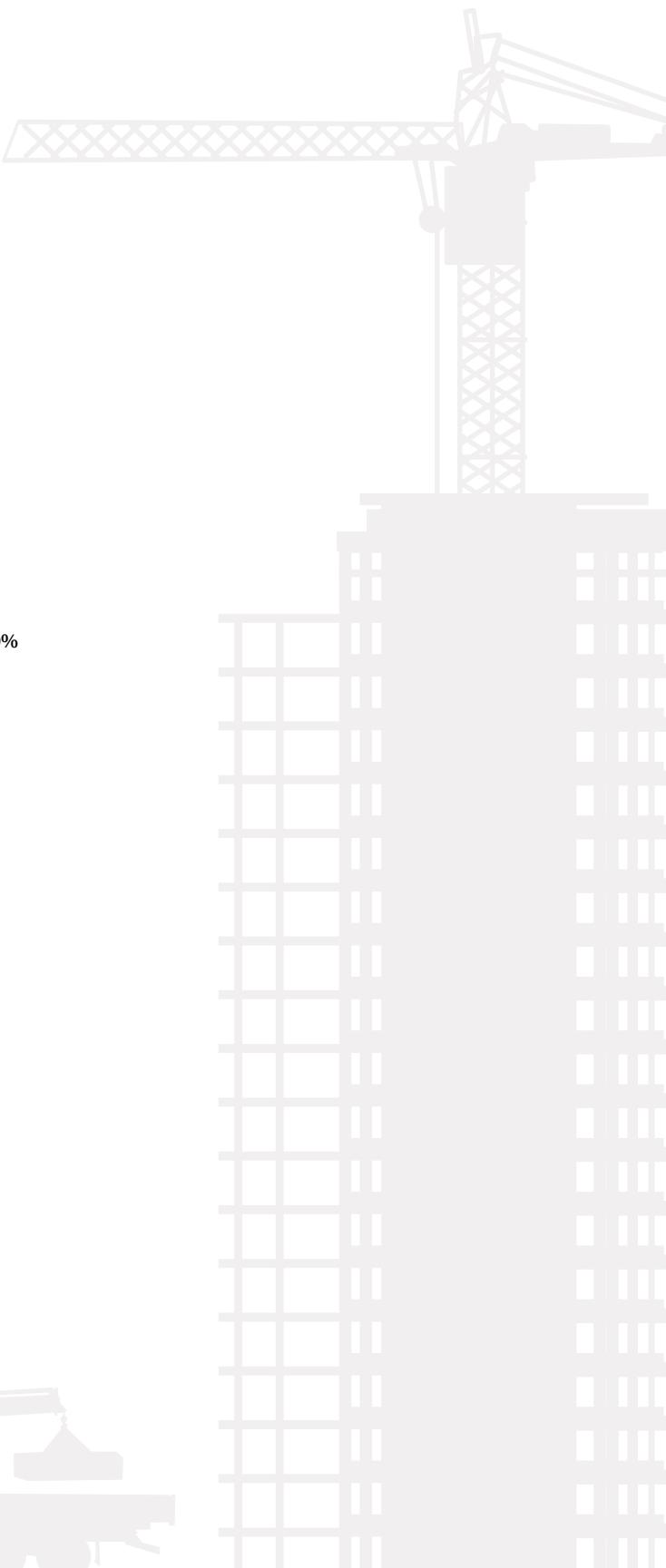
Base: 84



“ Respondents believe greater focus on improvements in project planning, governance and risk management will be key to achieving more efficient public spending on infrastructure.” **”**

Continued pressure on funding

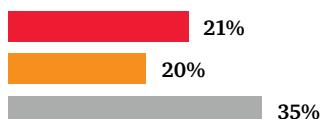
Widespread fiscal consolidation by governments across the region means that the pressure on funding will remain intense. 74% of respondents (who commission projects) are likely to increase spending, however, they feel that funding and liquidity restrictions may have an negative impact on their projects.



Q. To what extent do you expect the availability of funding to impact your capital projects over the next 12 months?

Base: 77

I do not anticipate any funding issues



I expect some funding restrictions, which will have minor impact on my projects



I expect major funding restrictions, which will have severe impact on my projects



Don't know



■ 2018 ■ 2016 ■ 2014



Industry outlook and challenges

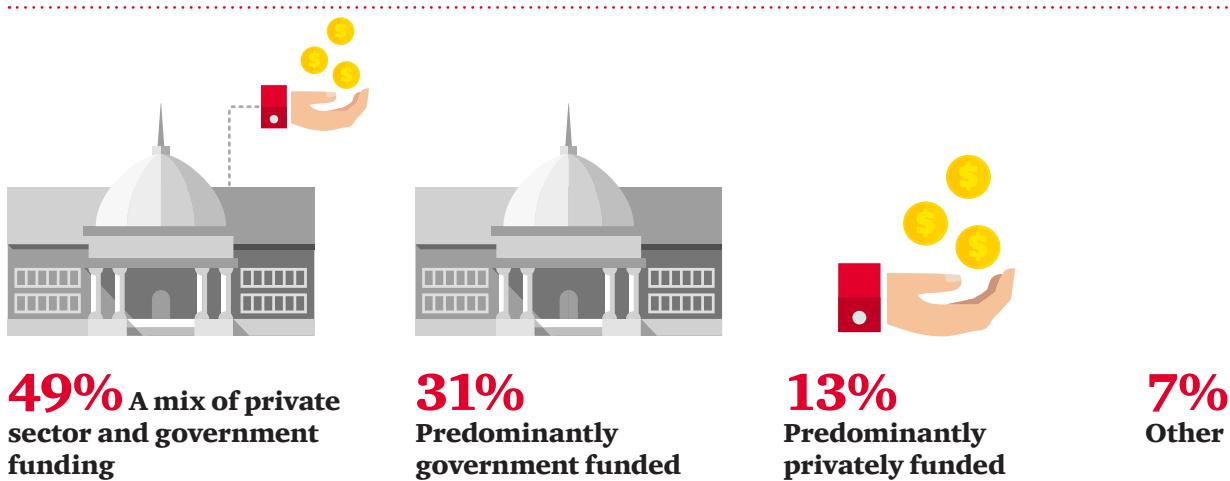
Private capital to the rescue ?

Against the background of constrained public finances, there is widespread belief that more private capital will be required to fund future projects, an impression reinforced by numerous government announcements seeking private sector involvement in capital projects across the whole region.

Respondents believe that private sector finance would be either important or very important for appropriate major infrastructure projects in the Middle East. *“The public sector cannot continue financing all the required developments. Private sector financing is the only alternative to achieve sustainability”* was typical of respondents’ comments on this topic. Half of respondents expect a mix of public and private capital to fund future projects.

Q. How do you expect infrastructure projects in your region to be funded over the next year?

Base: 78



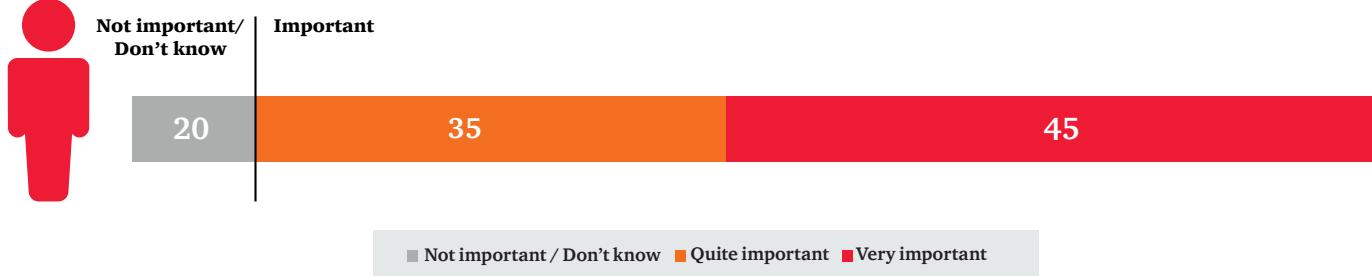
Future financing

Against the background of continuing funding constraints, 80% of respondents believe that private sector capital will play a bigger role in the sector in the longer term, whether through Public-Private Partnerships (PPPs) or fully private-sector projects. However, private sector funding also faces constraints and the sector needs to tackle its historic problems with poor budgeting and risk management, along with improving collaboration with suppliers, if greater private sector capital is to be attracted.

“
8 out of 10 respondents agree on the importance of private sector financing in the longer term
”

Q. In your opinion, how important or unimportant is private sector financing for major projects in the Middle East?

Base: 78



However, the desire to attract private capital goes beyond the need to ease pressure on public sector budgets. Respondents said the benefits of working through Public-Private Partnerships included access to the greater experience available in the private sector, and a higher likelihood of delivering capital projects on time and on budget.

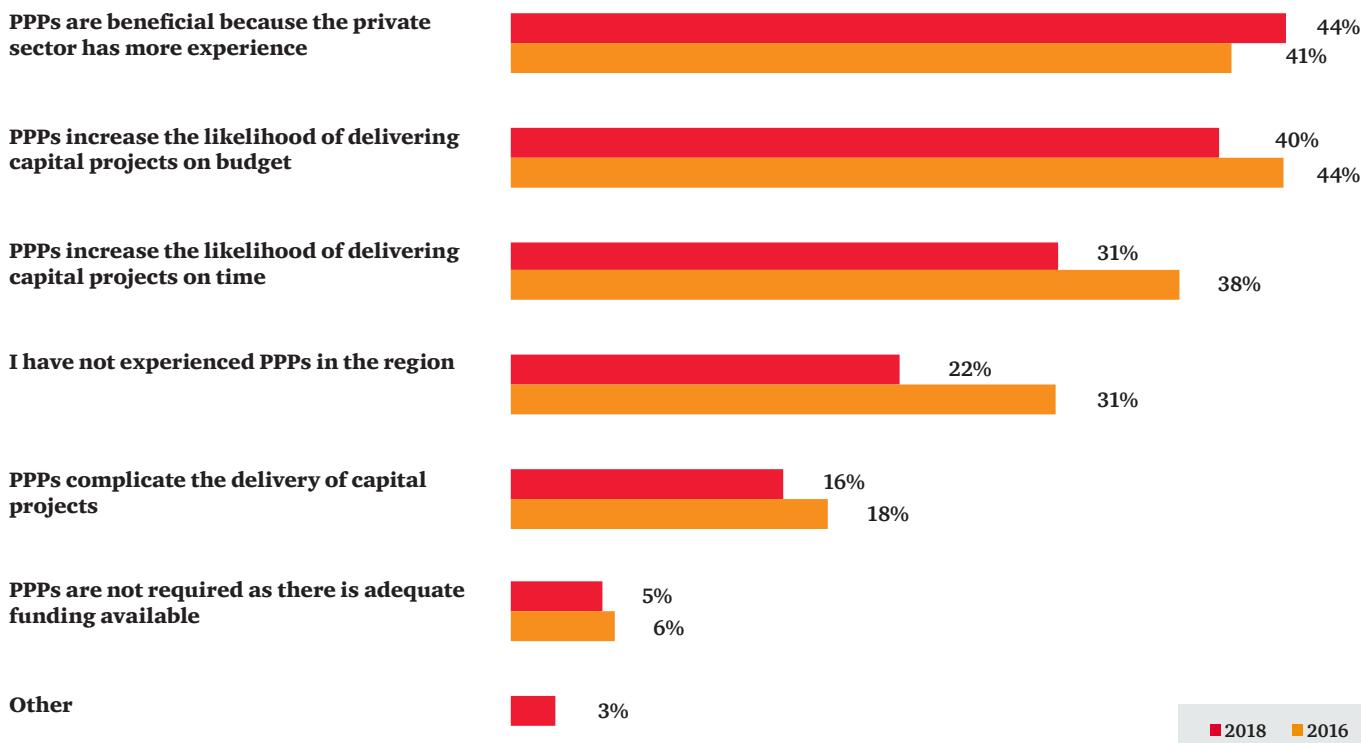
It is important to note that PPPs encompass both construction and long term operations and it is this combination which results in better 'whole of life' value engineering. It is this expertise and experience, along with long term debt financing that the private sector can bring to appropriate projects.

To date, the take-up of PPPs in the Middle East has been slow outside of the utilities sector. PPPs will not be the solution to all the challenges the sector faces. However, if appropriate projects which are suitable for long term private financing (incorporating both capex and long term opex) are carved out of traditional budgets, fiscal relief will be achieved.

Inefficiencies in planning and public investment remain critical along with a shortage of key capabilities in the public sector continues to present barriers to greater private sector involvement. Until government agencies and departments truly understand how and why PPPs work, the influx of private capital into the sector will continue to stagnate.

Q. Which of the following statements do you consider apply to Public Private Partnerships (PPPs)?

Base: 77



Conclusion

The slowdown in the commissioning of construction projects since 2016, combined with financial stress among major contractors, highlights the pressing need for reform and change across the industry. Governments are increasing pressure on ministries and agencies to improve their planning, budgeting and forecasting. They are also being told to strengthen their in-house capabilities to secure better value outcomes with the public money they are spending. In this era of fiscal restraint, it is no longer acceptable for the industry to continue working in an environment of continuous delays and cost overruns.

Many contractors remain poorly capitalised and short of working capital. Without more stable finances, they will not be able to invest in the technology and other innovations that would enable them to increase efficiency to deliver better performance.

This may prove a barrier for contractors to bid for certain projects. For example, as part of its drive for more collaborative project planning, greater efficiency and better risk management, the Dubai government has made building information modelling (BIM) software mandatory for most major projects in the Emirate, including hospitals and educational facilities.

Private capital may well play a bigger role in financing future projects. In any case, there needs to be a much more effective collaboration between customers and contractors that recognises that contract awards based on “lowest cost wins” very often fail to secure the best ‘whole of life’ outcome in value terms. Lowest cost decisions give key players in the construction supply chain little capacity or incentive to invest in initiatives that would deliver better quality and value over time.

Improvements in the levels of awareness and knowledge of PPP mechanics within state owned enterprises will also need to improve before international private sector capital will be deployed on a long term basis to infrastructure sectors such as transport, education and housing. With that said, there are efforts underway to tackle this in the region through the development of private financing/PPP guidelines and laws to aid government agencies in making the right decisions on expenditure.

In the year ahead, the industry faces a series of major changes, including the recent implementation of VAT, as well as accounting changes under IFRS 15 relating to recognition of revenue from contracts. There are some signs from the survey that performance may be improving. It is now important that the lessons learnt about project management and governance are not forgotten about in the wake of increased spending; the industry would miss a major opportunity to improve long term performance if it simply reverts to historic practices as spending starts to rebound.

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