

The New Economic Reality

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Background to today's talk

- The lawyer's view based on
 - what we have been seeing in Hong Kong
 - what we have been seeing elsewhere in the world
 - my predictions based on some past experience
- I need to look briefly at market conditions in order to explain my views about what the new economic reality is and how the various participants could respond to it.

The Hong Kong Market - today

- A Construction market with no growth and few major projects in recent years
- Tender prices falling significantly in 2009 following three or more years of increases
- The consequences were to a degree ameliorated by the construction boom in Macau
 - But many Macau projects have either been suspended, shelved and or are reaching completion (Construction Investment down 32.7% in Q2 2009 compared to previous year)
- The result has been a loss of labour and skills, particularly at the trades and management levels
- Many major international contractors, specialist subcontractors and consultants reduced their commitment to Hong Kong due to:
 - Lack of major projects
 - Intense competition (particularly from mainland contractors)
 - Unacceptable margins
 - Payment delays

The Hong Kong Market – in the future

- The Major Projects
 - Some will be with us soon but later than the construction industry would have wanted
 - Possibly some other “government” projects beyond the big 10
- Although some movement in Housing market, private sector (commercial and industrial) will, in my view, remain in decline for some time:
 - Reduced demands for Hong Kong exports of goods and services
 - Businesses are finding finance for development difficult to obtain
 - The speed and depth of the economic collapse has meant that entrepreneurs are cautious and have little appetite for investment
 - Some projects that have been delayed are being released but these will be the exception and probably the subject of some value engineering

The Hong Kong Market – in the future

- Against this background what can we anticipate in Hong Kong?
 - For the major projects
 - The return/increased interest of some major international contractors (probably participating in JVs)
 - The return/increased interest of some major other players (specialist subcontractors, suppliers and consultants)
 - For lesser government projects
 - Continued activity
 - Probably still little progress with PPP type projects

The Hong Kong Market – in the future

- For private sector projects
 - A shortage of new work
 - Payment problems for work started before the crisis
 - LDs
 - Counterclaims for defective work
 - Delays in accepting completion
 - Where private employers are forced to proceed with projects, many will be doing everything they can to reduce cost and extend their cash flow

Factors mainly outside Hong Kong

- Several International Contractors, Consultants and Specialist Subcontractors are already planning
 - their return to Hong Kong, or
 - expansion of their existing Hong Kong business
- They have been having and continue to have difficult times
- Many major contractors are facing
 - projects that have been suspended or terminated
 - projects where they are owed money by employers who will not or cannot pay

Factors mainly outside Hong Kong

- Many major contractors are facing (cont'd)
 - projects where there are substantial claims brought to extend the Employer's cash flow
 - Defects
 - Liquidated Damages
 - dubious Bond calls
 - sub contractor and supplier insolvencies
 - investments in SPVs for PPP projects that they cannot now realise
 - a difficult bond market
 - problem contracts where they cannot afford to write off losses – resulting in an inevitable and unavoidable diversion of resources
 - claw back of fluctuations
- All against the background of restricted available financing for their business

Factors mainly outside Hong Kong

- Many consultants
 - have invested heavily in preliminary work for projects that have not proceeded
 - have serious bad debt problems
 - have severe restrictions on funding imposed by their bankers – who used to see them as a safe bet
- Many subcontractors are
 - experiencing the knock on consequences of the very matters that are impacting main contractors
 - the victims of similar actions by main contractors to those which main contractors have suffered from Employers
 - subject to main contractors steps to preserve their cash flow
 - Even where pay when paid is not allowed it is often a fact of life – particularly where there is no compulsory system providing for security for payment
 - Experiencing the same restrictions on funding

Factors mainly outside Hong Kong

- Although this section is described as “Factors mainly outside Hong Kong”, some of these problems on projects have been encountered in Hong Kong but not to the same extent as elsewhere
e.g. in UAE 52% of 1,289 projects were cancelled or suspended in 2009 Q1
- But the problems of bank funding can be the same

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- The apparent “boom” from the recovery packages will have areas of fragility
- The risks are
 - that the need for many participants in the industry to participate in the stimulus projects will lead to
 - Aggressive pricing
 - Acceptance of unreasonably onerous contract conditions
- There will be
 - Labour shortages
 - Skills shortages
 - Tradesman
 - Management
 - Materials shortages
- Skills and materials will be taken by the major projects – causing more severe shortages on lesser projects.

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- Participants
 - who are vulnerable to the consequences of projects hit by the economic crisis
 - who because of the liquidity problems do not have the same facility to fund cash flow problems as they may have had in the past
 - government support of financial institutions has not resulted in greater liquidity
 - lenders are very cautious and often looking at lower risks than construction
 - so they are not in a position to store up entitlements/claims for resolution at some future date
 - who will be vulnerable to the skills shortages
 - who may have difficulty in meeting onerous bonding demands
- The result is a climate for potential problem contracts and disputes

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- Some consequences
 - Due diligence will be necessary to check the resilience of all participants (other than Government)
 - The risk of the failure of a JV member needs to be assessed
 - Supply Chain Management becomes even more vital
 - Contractors need more than ever
 - » to know their subcontractor, his other contracts and his access to the necessary expertise
 - » to recognise the risks of involving him on several projects
 - Do the Consultants have the financial muscle and suitable staff available for the project?

The New Economic Reality for Hong Kong - Some thoughts

- My experience is that problem contracts are usually a problem for all concerned
- Unreasonably onerous conditions are rarely the answer
 - certainty of claims
 - risk of non completion
 - risk of insolvencies
- The New Economic Reality should be recognised by all concerned in the construction process and result in an open sharing of the problems.

The New Economic Reality for Hong Kong - Some thoughts

- Approaches where everyone recognises the risks and vulnerabilities
e.g.
 - by a sensible risk recognition and sharing regime
 - e.g. ground conditions
 - by the incorporation of effective real time dispute resolution techniques so as to recognise the funding difficulties faced at all levels
e.g.
 - NEC 3 style processes for speedy resolution of disputes or waiver of claims
 - adjudication,
 - a new approach to mediation with Government
 - Perhaps the abandonment of pay when paid clauses
(beware the direct payment option)

The New Economic Reality for Hong Kong - Some thoughts

- by recognising the bonding difficulties
 - would not a parent guarantee or a conditional bond be sufficient?
- by advance payments secured by parent company guarantees to assist with cash flow
- recognition of the problems that are likely due to labour and material shortages (e.g. possibly a study of the impact of so many projects followed by an EOT entitlement where unforeseen)

The New Economic Reality for Hong Kong - Some thoughts

- Fluctuations clauses
 - Perhaps with a threshold
- Employers accepting/sharing the risk in currency fluctuations
 - Employer/Contractor
 - Contractor/Subcontractor
- A realistic approach to calculating Liquidated Damages
 - can be very difficult for employers if based on today's "cost" of a capital investment

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Conclusion

- The consequences of the world economic crisis are that many participants in the construction process
 - are more vulnerable than before
 - have less ability to finance cash flow problems arising from the occurrence of some kinds of risks
 - will have less or no bonding ability
- now is the opportunity to pursue a more open approach to risk sharing and to resolving disputes that are damaging to cash flows.

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Thank you

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