Aon Risk Solutions
Global Construction & Infrastructure Group

Global Construction Financial Stability– A Weakening Foundation?

March 2018

Empower Results®

Table of Contents

Introduction

Total global construction spend has been growing at a faster rate than GDP since the financial crisis; while simultaneously, project sizes and contractor volumes have been increasing substantially. Growth in the construction industry has been facilitated by historically low interest rates and an increasing focus on addressing a global infrastructure deficit. The increased size and complexity of projects has been a catalyst for globalization of a formerly mostly local industry.

As the construction sector continues to globalize, supply chains increasingly diversify, and central banks signal somewhat tighter monetary policy, some contractors may be put in tough positions as they become more exposed to these new market dynamics. These issues are contributing to a worrisome, conflicting combination of events: increased infrastructure demand met with a potential contraction in construction capacity. This is indicated by recent experiences of some of the largest global contractors showing increasing signs of fiscal stress through lower margins and increasing disputes, claims, strains on liquidity, and in some cases, project and/or enterprise default.

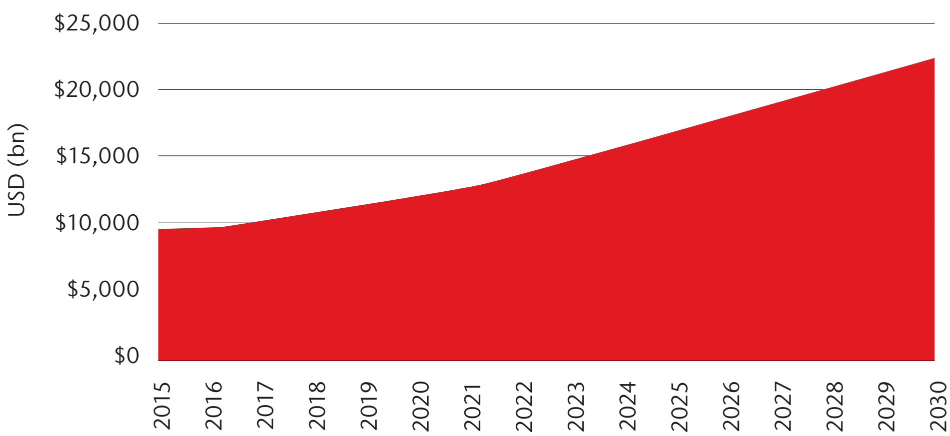
Market conditions, like increasing interest rates, can add stress to an industry that is already facing challenges of being able to adequately supply its services. These market conditions present an elevated state of risk for firms supplying contracting services as residual effects of recent firms' failures combined with financial pressures, suggest a need to adopt a more rigorous approach to risk assessment, quantification, mitigation, and transfer.

Reading the Tea Leaves – Signs of Trouble Ahead

Through a variety of data sources, Aon has identified a few trends that indicate a potential contraction in construction capacity is on the horizon. Much of the downside of these indicators can be mitigated through prudent risk management and implementing strategies that would be appropriate regardless of the potential for disruption.

Before elaborating on these indicators, it's important to first point out that global demand for construction is forecasted to continue to expand with the rate of growth between 5.5% and 7% through 2030. With this frame of reference, any contraction in the supply of construction services could put the industry in a dire situation, further elevating the importance of addressing variables inducing stress on the construction supply community.

Global Construction Spend Forecast
(Nominal, Nonresidential and Residential)

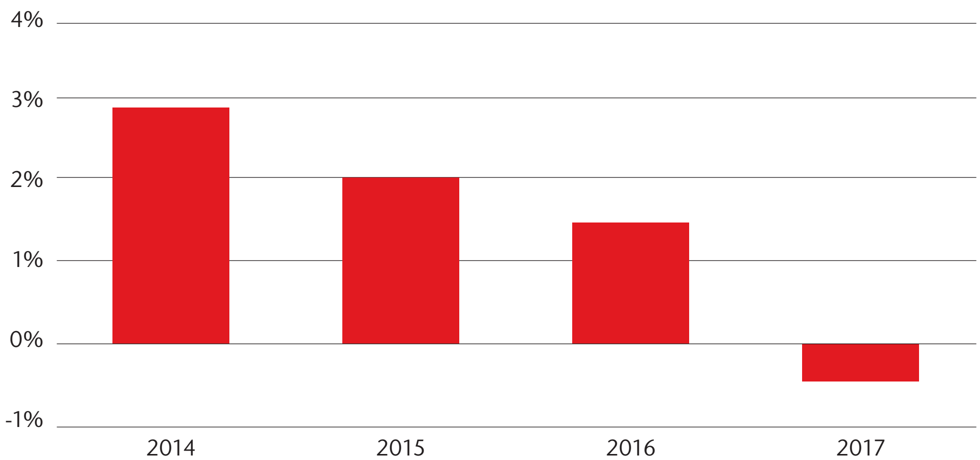


Source: IHS Markit

Financial Stress Pushing Some Contractors to the Brink of Collapse

While the construction industry has never been known for having particularly high profit margins, the global financial crisis left many contractors struggling to post profits. While the global economy is recovering, some contractors are still struggling to return to profit. This is especially pertinent in the UK, where pretax profit margins among the top 10 contractors have been on the decline since 2015. Thinner margins leave less room for error and can lead to cash flow concerns or worse, the inability to continue operations. Financial results published through 2017 show that some of the top global contractors are facing challenges, with many delivering single digit margins exacerbated by a negative trajectory for most.

Top 10 UK Contractors Average Pretax Margin (2014-2017)



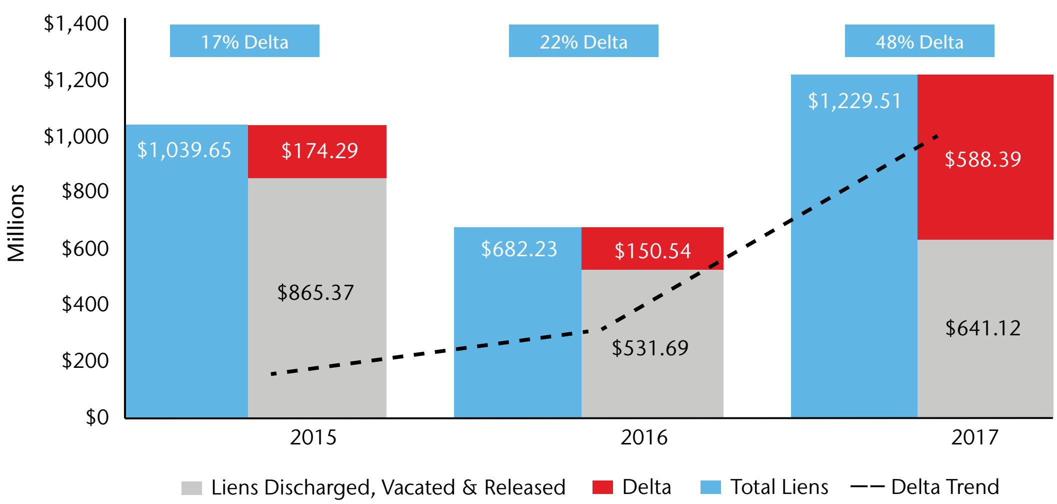
Source: CN 100 report 2014-2017; constructionnews.co.uk

Since the global financial crisis, there have been several firms unable to navigate these market dynamics resulting in high profile financial restructuring efforts and in some cases, filing for bankruptcy protection. Carillion is the most recent example of a large, global construction firm unable to complete a financial restructuring causing them to discontinue operations and move into liquidation. The fallout of their default is still being quantified, but it is causing disruptions around the world due to the firm's international presence. There have been a few high profile profit warning announcements from UK contractors, causing many to wonder if there are more dominos to fall after Carillion.

Supply Chain Suffering from Cash Flow Delays

When there is financial stress at the main contractor level it can trickle down the construction supply chain and put strains on the cash flow statements and balance sheets of all stakeholders. Steady and sustainable cash flows are paramount for contractors and subcontractors to both allow them to take on new projects and act as a cushion when problems arise on projects. Balance sheets and cash flows are put in jeopardy when payments between key stakeholders are delayed or tied up in dispute. Publicly available data from Ontario, Canada's largest provincial economy, shows an increase in the difference between total registered liens and discharged liens, meaning there is an increasing amount of money tied up in dispute. Additionally, data from Arcadis shows that both the global average dispute value and duration of disputes have been increasing over the past 6 years.

Liens Filed vs. Discharged - Ontario, Canada



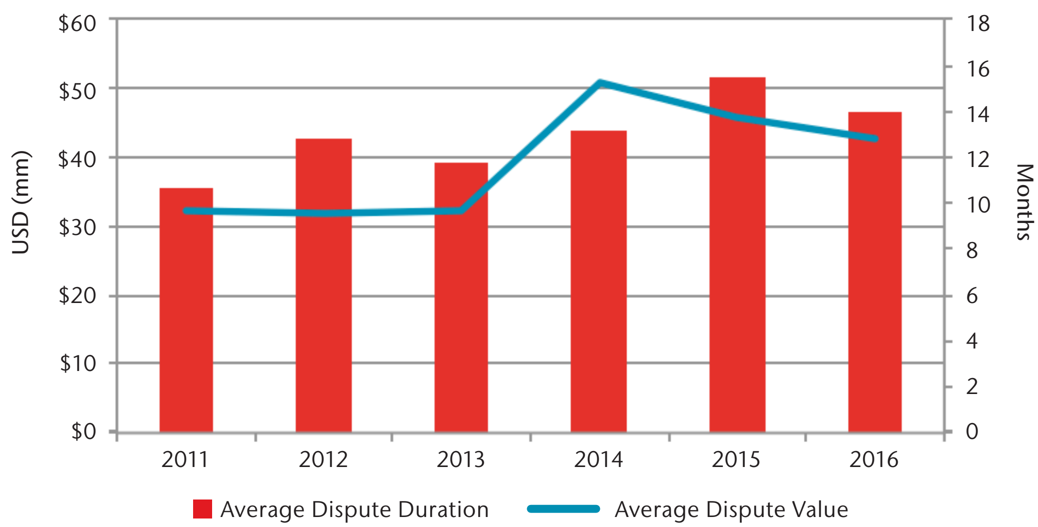
Source: Lumbermen's Lien Data

Continues next page

Supply Chain Suffering from Cash Flow Delays

Continued from previous page

Global Dispute Overview



Source: Arcadis Global Construction Dispute Report

Frustration over cash tied up in dispute has caused some governments to take notice and pass laws to mitigate this. The Ontario government in Canada recently introduced their new prompt payment legislation to modernize the lien and holdback processes to resolve disputes faster.[1] In the UK, suppliers and subcontractors are demanding legislation that would reduce late payments from upstream stakeholders as they claim that these late payments are disrupting cash flows and undermining investment in safety.[2] These two examples shed light on the pressure put on downstream parties, a contributing factor to the financial fragility of the global construction economy.

[1] https://news.ontario.ca/mag/en/2017/12/ontario-passes-legislation-to-modernize-construction-laws.html

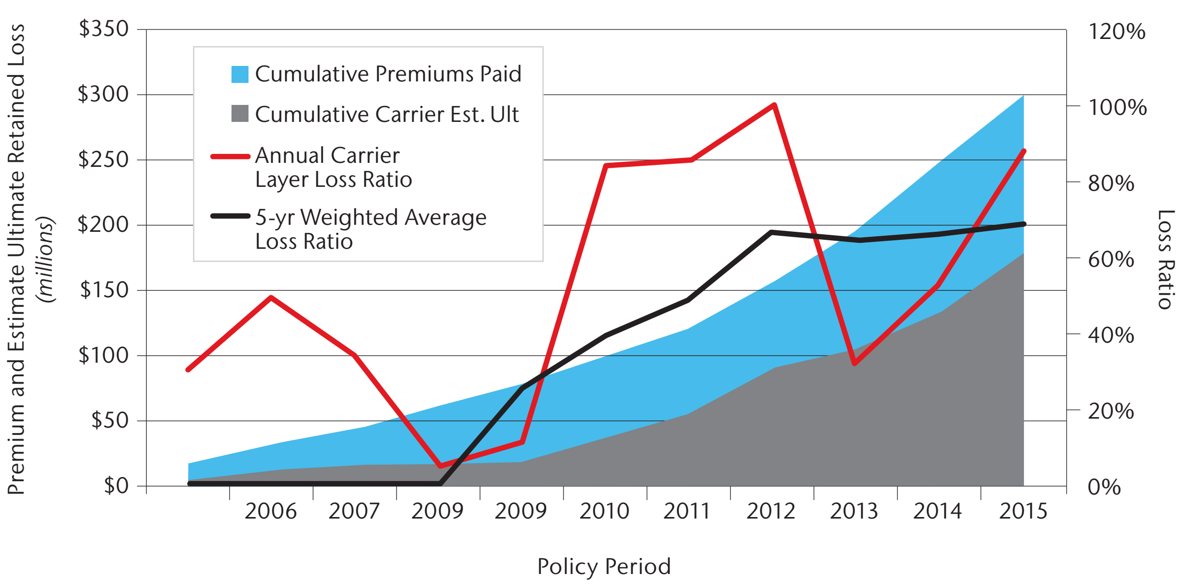
[2] https://www.thetimes.co.uk/article/construction-suppliers-demand-end-to-late-payments-70n7c2dn2

Potential Contraction in Surety and SDI Capacity

As mentioned in Aon's 2017 Surety Market update,[1] sureties maintained low loss ratios and profitability in 2016. Based on the Surety & Fidelity Association's posted results for the U.S. surety market through Q3, it is expected that when the final results are posted for FYE 2017, 2017 will bear out as another year of top-line growth and low loss ratios resulting in strong profitability for the majority of the markets. Global loss ratios for both the primary and reinsurance markets are difficult to assess, but we expect that the impact of the most recent defaults originating in Europe and the potential for additional defaults going forward, will increase loss ratios for the sureties in the near future. There are already indications from the industry of an increasing amount of contractors being moved to more intensive monitoring positions, which we don't expect to change as many may be concerned by the Carillion situation. Additionally, the subcontractor default insurance (SDI) marketplace has continued to experience losses stemming from the post financial crisis recovery, as reflected in Aon's loss data below. As these loss ratios reach breach profitability thresholds for carriers, underwriters have begun to react to the results by adjusting rate, retentions and coverage in order to stabilize results.

Both surety and SDI are important performance security tools available to contractors to help protect their balance sheets. The economic conditions and the compromised financial position of large contractors point to a potential market hardening in capacity and rates in the global marketplace.

Carrier Layer Historic Ultimate Loss, Premium, and Ultimate Loss Ratio at Estimated Ultimate Values (2005 - 2015)



Source: Aon Canada

[1] http://www.aon.com/usa/attachments/2017-Surety-Market-Update.pdf

Navigating Trouble – Selected Suggestions on Surviving a Construction Capacity Contraction

The combined factors mentioned above imply that there could be storm clouds on the horizon for the global construction economy. Whether this event is imminent or not, ensuring preparedness for a potential contraction in overall construction capacity is a vital practice for any construction executive. Shrewd risk managers know that their main priority is protecting the firm's financial wellbeing from all aspects of risk. Key strategies to achieve this goal include ensuring the performance of your surety credit facility, finding solutions to address subcontractor risks, and employing sound operational practices.

At Aon, we offer a full surety and bank credit benchmarking analysis with insights into where industry leading terms for such security are coming from, including the cost of credit, capacity, security terms, and the global reach of the facility. Knowledge that your surety credit facility can withstand a downturn in all economic climates allows for confidence in avoiding a scramble to find new sources of competitive performance security credit in the event of a contraction.

In addition to securing competitive performance security, having the right risk financing solutions in place can mean the difference between prompt payments and outstanding accounts. With the recent insolvency of Carillion in the UK and concerns about others, subcontractors and suppliers throughout the world have been left with substantial amounts in unpaid and at-risk receivables. This cash shortage can initiate a domino effect down the supply chain and back up affecting other main contractors. Main contractors can better protect themselves, their supply chain, subs, and clients (owners) through risk solutions such as subcontractor default insurance, payment bonds, export agency solutions, and, when appropriate, parental guarantees. Finding the best solution allows for maximization of creditworthiness, and the ability to mix and match solutions to meet your firm's needs can give flexibility in negotiating terms.

Insurance solutions are not the only options in addressing risk in a potential future contraction in capacity. The first line of defense is ensuring that sound operating practices are in place to prevent and/or mitigate the impacts of performance disruptions to the construction supply chain.

Some of the key operational areas of focus include:

1. Go or no-go assessment practices (size, jurisdiction, type of work, supply chain, etc)
2. Counter-party risk assessment and prequalification
3. Bid award practices (i.e., evaluating wide bid spreads)
4. Contract execution practices
5. Default assessment practices
6. QA/QC practices
7. Technology (make construction more like manufacturing)
8. Training (your employees need to adhere to best practices to ensure they work)

Conclusion

Bringing aboard a trusted advisor can help in exploring the right solutions for the problems faced in uncertain market conditions. While in some areas of the world, contracts and subcontractors deal directly with their surety, bank, and in some cases, their insurers, this strategy may be an impediment to efficient capital in the event of a contraction. An advisor that has a comprehensive view of the global surety, bank and insurance marketplace can bring certainty to a contractor that they are truly getting industry leading terms.

There are signs in the global economy and on contractors' balance sheets that show that the construction industry may be heading toward precarious times. The mismatch in potential construction capacity and the projected demand for infrastructure services means that stakeholders need to start imagining what they would do to prevent or mitigate harm from a contraction in capacity. Firms that are adequately prepared to address these risks will be in the best position to capitalize on the increasing demand for services, however it is often too late to take action once the contraction has hit with full force. Sitting down with your advisors and making actionable plans will help limit downside to your employees, management, and shareholders/taxpayers, while positioning you to capture the upside from those who failed to plan.

About Aon

Aon plc (NYSE:AON) is a leading global professional services firm providing a broad range of risk, retirement and health solutions. Our 50,000 colleagues in 120 countries empower results for clients by using proprietary data and analytics to deliver insights that reduce volatility and improve performance.

www.aon.com

GDM05760

Empower Results®