THE BDO 2019 CONSTRUCTION SURVEY REPORT

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FOREWORD

JAMES MACQUEEN

Construction and Real Estate Sector National Leader

New Zealand's construction and real estate industry, including its product and service providers, is the largest sector in our economy, and is one of the largest employers. As such, it is a contributor to, and indicator of, the strength of our economy.

Historically, construction has experienced boom and bust cycles which have impacted employment and had a flow-on effect to the wider economy. It is currently experiencing its longest and strongest period of strength and this is forecast to continue. However, the sector is also facing significant challenges that place the sustainability of this growth and the industry participants at significant risk.

Operating a construction business presents unique challenges. The project nature of the work creates contract risks, uneven activity levels, resourcing challenges and difficult cash flow situations. Construction businesses need to provide performance bonds at the start of a project (often more than the profit that will be earned), and hold funds in trust to cover retentions. This means financial demands are extremely high.

Due to the unique nature of the industry, the profit measurement, accounting and taxation aspects are sometimes poorly understood, and the consequences of errors significant. As such, construction businesses can benefit hugely from specialist advisers that understand the challenges and issues and are able to provide appropriate advice.

Following our initial survey in 2018, BDO surveyed 216 NZ construction businesses in May 2019 on an anonymous basis (up from 100 participants in 2018). This mainly covered construction companies and subcontractors, but also included material suppliers and consultants. The sectors covered housing (including apartments), commercial construction and civil/infrastructure. The majority of participants were construction companies and subcontractors in the housing and commercial sectors.

At times, we have compared the 2018 and 2019 results to provide additional insights. Due to the number of participants in some sub-categories it is inevitable there will be some statistical variances, but the key messages are still apparent.

The key theme from the survey and from our experience assisting clients is that the sector is becoming increasingly divided between the good operators with strong financial and operational attributes, and those with significant fragility. The recent high profile insolvencies demonstrate this.

Our thanks to those who took part in this research. We hope the results presented in this report will provide a useful insight into the reality of the New Zealand construction sector today.

OVERVIEW

NICK INNES-JONES

Construction Specialist

The sector as a whole continues to grow, and forecast projects available support the opportunity for further growth. However, there are significant industry-wide challenges, with respondents particularly concerned about staffing, bureaucracy and the rising cost of compliance, as well as the economy.

A number of recent high-profile insolvencies have profoundly changed the way that businesses respond to risks. It should be no surprise that cash flow and bonding capacity have deteriorated, which will constrain growth.

Gross margins have slightly improved but are still inadequate to maintain a healthy sector. Due to intense competition and a focus on providing services at the lowest cost, many subcontractors' margins remain too small for long-term viability. Head contractors greatly need these subcontractors to undertake available projects - the survival of both depends on it. The industry therefore needs to focus its attention on the survival of capable subcontractors.

Retentions regime compliance seems to have improved but at a financial cost to cash flow and bonding capacity. Inappropriate transfer of risk and the impact of unreasonable contract disputes is placing additional burdens on those companies.

Too many businesses with older shareholders have still not adequately addressed their succession planning and risk leaving this too late. Our team are assisting with a significant number of succession plans. The dynamics and needs are slightly different in each situation, so getting tailored advice is essential.

Outside of financial issues the most common challenges relate to securing and retaining sufficient experienced and committed people or subcontractors.

There are mixed messages in relation to forward work. Industry forecasts suggest increasing activity yet our analysis of the amount of forward work indicates that companies have less projects in the pipeline than a year ago. This varies by region, with the most significant decrease in the South Island.

The focus on lowest cost is a theme that permeates the survey responses. This is accentuated by poor understanding of costs and break even points compounded by poor management reporting and measurement of costs and profit. Our team have had to spend a lot more time improving underlying accounting and reporting in new clients than previously, and we need to do this before we can focus on other aspects of business improvement.

We hope this report highlights a number of actions for industry participants to consider help bridge the gap between the strong performers and those who are vulnerable and lack resilience.

NEW ZEALAND CURRENTLY HAS A 2-TIER CONSTRUCTION SECTOR WITH THE GAP WIDENING BETWEEN:

- The good operators with robust businesses
- Fragile businesses

Robust Businesses

- Profitable
- Strong cash reserves
- Robust balance sheets
- Strong forward workflow
- No big gaps between projects
- Good governance
- Quality management reporting
- Timely reporting
- Accurate and proven forecasting
- Strong project management
- Resilient systems
- Appropriate systems
- Strong experience (or access to it)
- Sufficient staff for committed work
- Reliable estimating
- Above average margins
- Tidy organised work sites
- No big job losses
- Spare bonding capacity
- Retentions held in trust
- Pay on time
- Get paid on time
- Cover for key roles
- A clear business plan
- Operate in a niche
- Communicated ownership succession plan
- Staff succession plan
- Strong and consistent culture
- Industry specialist advisors
- Controlled growth
- Projects delivered on time
- High quality finished work
- Competitive
- Sound track record
- Loyal and reliable sub-trades
- Adequately understand and price in risk

Forces Of The Downward Spiral

- Low margins
- Delayed projects
- Staff shortages
- Subcontractor/ principal failure
- Inadequate project documentation
- Tightening bank credit
- Transfer of risk down the chain
- Quality issues
- Councils
- Surprises
- Desperate tendering
- Tight budget projects
- Below spec, cheap materials
- Regulations
- Compliance costs
- Overzealous H&S
- Unreasonable payment certificates
- Inexperience
- Failure to price in risk
- Bonding constraints

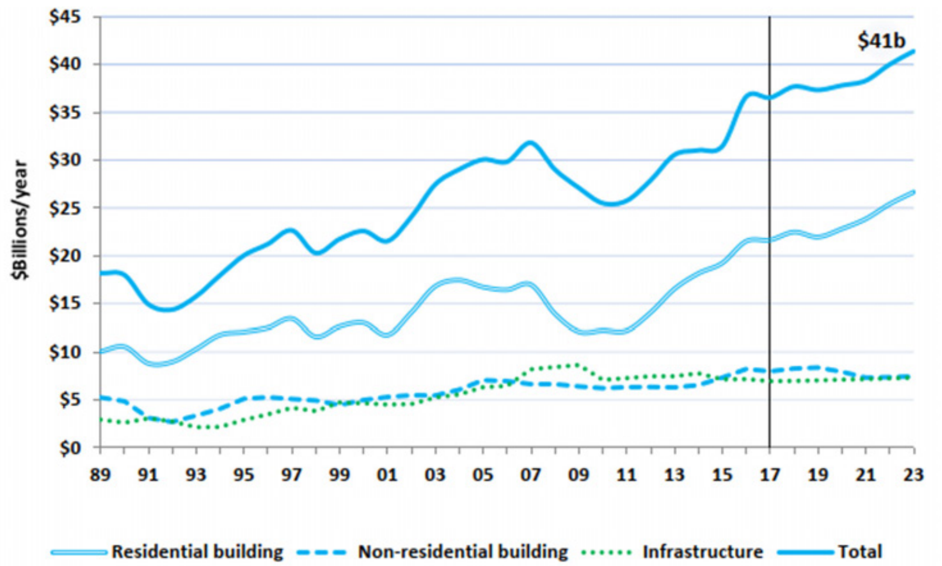
Fragile Businesses

- Breached bank covenants
- Untidy work sites
- IRD arrears, especially PAYE
- Poorly documented projects
- Retentions regime non-compliance
- High staff turnover
- Insolvent
- Poor planning
- Cost over-runs
- Poor estimating
- Poor reporting
- Inadequate governance
- The opposite of all Robust Businesses features
- Cash flow is a juggle
- Poor quality
- Slow to be paid
- Slow to pay others

GROWTH, CAPACITY AND FORWARD WORK

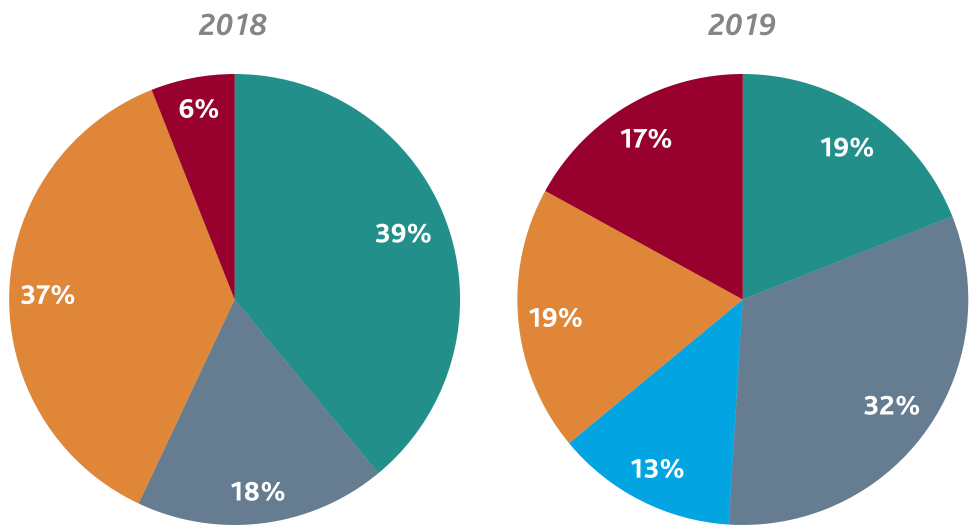
The following graph provides an overview of the construction cycles, growth and forecast growth.

All National Building and Construction, by value



Source: BRANZ/Pacifecon/Statistics New Zealand

Future Work Outlook



We have sufficient confirmed work for over 12 months

We have sufficient confirmed work for 6-12 months

We have sufficient confirmed work for 3-6 months

We have sufficient confirmed work for the next 0-3 months

We need more work

Industry capacity, physical and financial, has been the greatest inhibitor of growth. Additionally, high building costs impact project feasibility and finance limitations constrain growth. Despite the forecast level of work increasing, our 2019 survey reflects a significant change. Companies needing more work have significantly increased and those with more than 12 months forward work has significantly decreased.

When we delve deeper, the forward work in Christchurch has plummeted. 45% of Christchurch respondents have under three months' forward work. Under 10% have over 12 months' forward work.

THE SECTOR'S FORWARD WORK PIPELINE IS DECREASING

INDUSTRY PLAYERS CONTINUE TO FACE A CHALLENGING ENVIRONMENT AND HAVE A NUMBER OF CONCERNS REGARDING THE FUTURE

Staffing, cash flow, the rising cost of compliance and the strength of the economy top the list of concerns

When asked about their challenges and areas of concern, respondents specifically called out the risk of clients not paying and of debtor insolvency. Inability to recover retentions (or confirm that they are held in trust) or to meet bonding requirements was also high on the list. In addition, there appears to be concern over maintaining sufficient equity in the business.

Gross margins were a hot topic with many respondents raising concern over falling margins year on year, and the inability to effectively price for risk due to competitive 'price wars'. The effects of this 'race to the bottom' on profitability is being exacerbated by increasing costs.

SQUEEZED MARGINS AND INCONSISTENT CASH FLOW MEAN THAT INDUSTRY SOLVENCY IS A GROWING CONCERN

However, much like in last year's survey, the greatest challenge or concern highlighted by our survey respondents was staff, both in availability and quality. Specifically, respondents indicated that finding (or retaining) staff with the right skills and experience is challenging. It is also difficult for employers to find reliable staff with a strong work ethic. This skills shortage is, in turn, increasing the likelihood of poor workmanship and rework.

AVAILABILITY AND QUALITY OF STAFF IS A MAJOR CONCERN AND MORE NEEDS TO BE DONE TO BUILD A PIPELINE OF SKILLED WORKERS

Respondents expressed concern over the increasing cost of compliance. Unsurprisingly, many respondents mentioned compliance with certain elements of the Construction Contracts Amendment Act 2015, but other regulation impacts the industry. For example, many cited the amount of time spent on health and safety (versus time actually spent working) as a real issue. Enforcement of current standards is seen as a challenge – particularly given concerns with the skill level and workmanship of the current workforce.

In addition to this, local government rules and bureaucracy push out timeframes and respondents find it increasingly difficult to deal with Councils' red tape and processing times. The lack of experience of Council staff means finding resolutions to seemingly simple issues has become problematic.

Whilst access to quality staff and bureaucracy slows down a project's completion and increases the risk of litigation, many respondents were also concerned about the amount of time they invest upfront when tendering for business. This highlights real capacity issues in an industry which is already constrained.

COMPLIANCE IS COSTING TIME AND MONEY WHILE BUREAUCRACY AND PAPERWORK ARE TYING UP RESOURCES

Many respondents raised concerns regarding the quality of the design documentation (from drawings to design specifications) they have to work with.

THE SKILLS SHORTAGE ALSO EXTENDS TO LOCAL GOVERNMENT AND OTHER PROFESSIONALS IN THE INDUSTRY

Perhaps of most concern, a number of respondents said they are experiencing work-related stress as the industry challenges mentioned previously take their toll. Given the risk posed by stress on both mental and physical health, it is important that industry players take their own wellbeing into account and address this sooner rather than later.

MENTAL HEALTH RISKS LOOM AS THE INDUSTRY'S CHALLENGES TAKE THEIR TOLL

With many respondents citing concerns over an industry slowdown and lack of profitable incoming work, it is of little surprise that economic outlook is high on the radar. There is a regional theme to this. Some respondents are concerned about the threat of a recession or of a property downturn, as well as of further changes in the banking environment – resulting in tighter access to funding / bonding or prohibitive covenants.

Auckland-based respondents were also concerned about a lack of appropriate infrastructure and the cost that it adds to jobs.

CONCERNS OVER THE ECONOMIC OUTLOOK ARE HIGH ON THE RADAR

The industry is becoming increasingly segregated between those that are struggling and those that have strong profits, strong balance sheet, a great team, and are well placed to capitalise on the opportunities. There is an increasing level of forward work available to them and their preferred subcontractors.

SEIZE THE OPPORTUNITIES

THE REAL THREAT OF INSOLVENCY AND WHAT THE INDUSTRY IS DOING ABOUT IT

The majority of businesses have responded by making changes to their risk acceptance and margins

Over the last 12 months the construction sector has been significantly impacted by a number of high-profile insolvencies and also let down by subcontractors who are over-committed or unable to perform. In light of this, we asked what changes businesses have made (on a micro level) in response.

MOST RESPONDENTS SAID THAT THE RECENT HIGH-PROFILE INSOLVENCIES HAD A NOTICEABLE EFFECT ON THEIR BUSINESS AND THE WAY THEY RUN IT

Client vetting and selection

The most common response is that businesses are now being more careful and selective of which clients or contractors they work with. Respondents have mainly taken action in three areas:

1. Stronger client due diligence processes, which include:

- Financial due diligence on prospective clients
- Greater use of credit control agencies and credit checking clients over a certain dollar threshold
- Vetting clients more than previously
- Ensuring the use of reputable contractors and undertaking reference checks for any new clients
- Obtaining a letter from the client's accountant regarding financial position

2. Tighter client selection criteria, which include:

- Only working for main contractors with whom there is an existing (and ideally long-term) relationship and established level of trust
- Identifying reputable entities, e.g. government rather than unknown privately-owned companies
- Working for clients where margins are healthy (e.g. one business ceased government work due to low margins; another moved from residential work to commercial work)

3. Fiercer contract negotiation and tendering, which include:

- Signing an industry standard contract which spells out default process and gives legal protection
- Moving from tender work to negotiated contracts
- Avoiding price wars in favour of cash flow positive terms (i.e. ensuring a project is not a loss leader)
- More detailed review of contract conditions
- Limiting scope of work within the business' own speciality
- Being more selective of what work they tender for, rather than chasing all opportunities

The next most common responses to the recent high profile insolvencies related to improving margins, managing retentions and strengthening cash collection processes.

A DETAILED RISK ANALYSIS AND DISCUSSION SHOULD BE A STANDARD AGENDA ITEM FOR ALL DIRECTORS' MEETINGS AND BE A DEFINING COMPONENT OF CONTRACT NEGOTIATIONS AND ACCEPTANCE

Margins

- Pricing risk into margins
- Improving margins through better cost management and improved reporting / margin disclosure
- Refusal to work for reduced margins

Cash Collection

- Greater debtor control including closer monitoring of slow paying or non-paying customers and immediately chasing debtors who don't pay on time
- Refusing to start new jobs with clients with outstanding debts
- Stricter enforcement of payment terms and conditions
- Progress claims or deposits in advance of work being completed
- Stricter credit terms throughout the projects
- Fortnightly progress payments

Retentions

- Not accepting retentions or liquidated damages clauses
- Reducing retention period

Financial

- Reducing overheads, e.g. by reducing staffing levels or changing premises
- Building balance sheet and taking less dividends from the company
- Improving frequency and quality of financial reporting

General Comments

- Do not overcommit
- More use of Personal Property Securities Register (PPSR)
- Ensuring compliance with Construction Contracts Act
- Investigating trade credit insurance
- Undertaking more subcontractor work themselves to reduce the risk
- Working on charge up, not contract
- Subcontractor performance bonds

CASH FLOW CHALLENGES ARE ON THE RISE: THIS CREATES RISK OF INSOLVENCIES

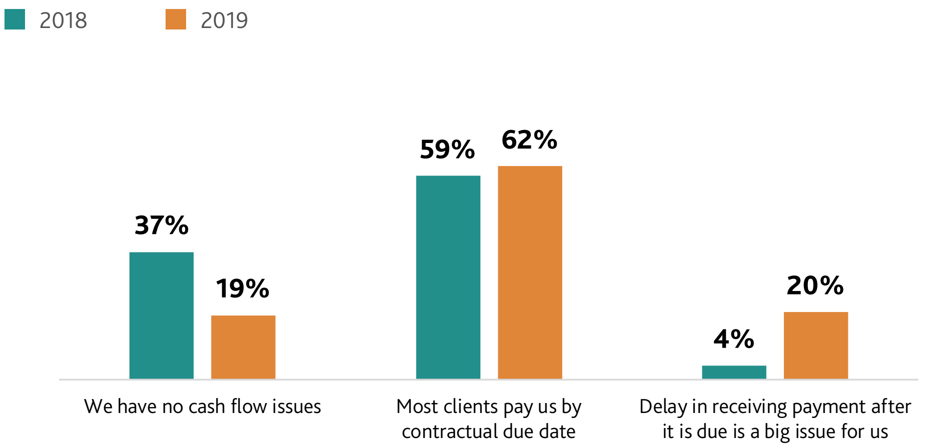
Cash is king in the construction sector. There is a contractual due date for payment and industry practice is to pay by the contractual date. In our 2018 survey, only 4% of respondents said that delay in receiving payment was an issue. In our 2019 survey this has increased significantly to 20%.

ONE IN FIVE FIND GETTING PAID ON TIME IS A BIG ISSUE

Subcontractors may be reliant on one head contractor for a high percentage of their income, and therefore cash flow. If that head contractor becomes insolvent and/or has major cash flow issues, it can quickly lead to the insolvency of the subcontractor. The subcontractor may not have the cash flow to pay staff and suppliers.

Many subcontractors have felt the cash flow pain of recent high profile insolvencies. It is a major concern that one in five said delay in receiving payment was a big issue.

In The Context Of Whether Cash Collections Is An Issue For Cash Flow



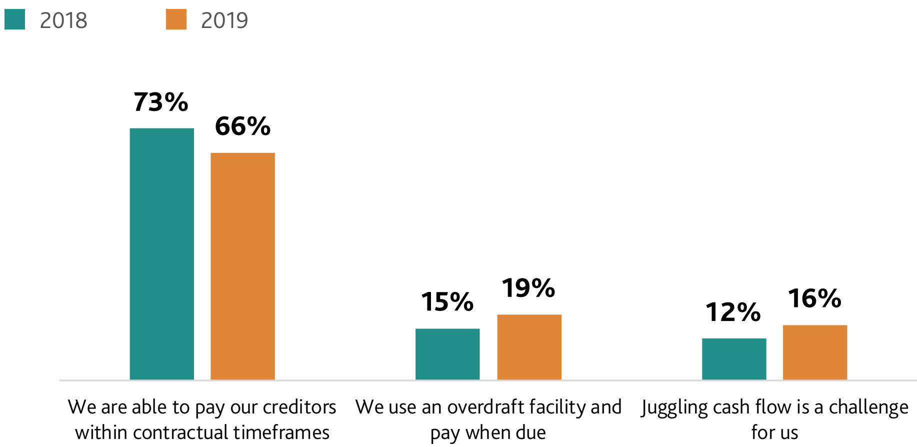
Cash resources are a greater challenge this year.

When asked about their ability to make payments when due, only two thirds of respondents confirmed that payment is made within the contractual timeframes - down slightly from 2018.

On the flipside, we have seen an increase in the number of respondents who rely on an overdraft facility to pay when due. It is concerning to see that 16% of our respondents said that juggling cash flow is a challenge.

Overall, one third of respondents say they use an overdraft or find it hard to juggle cash flow. This indicates that their resilience to even small shocks is limited, and signals that the industry's insolvency risks do not show signs of improvement.

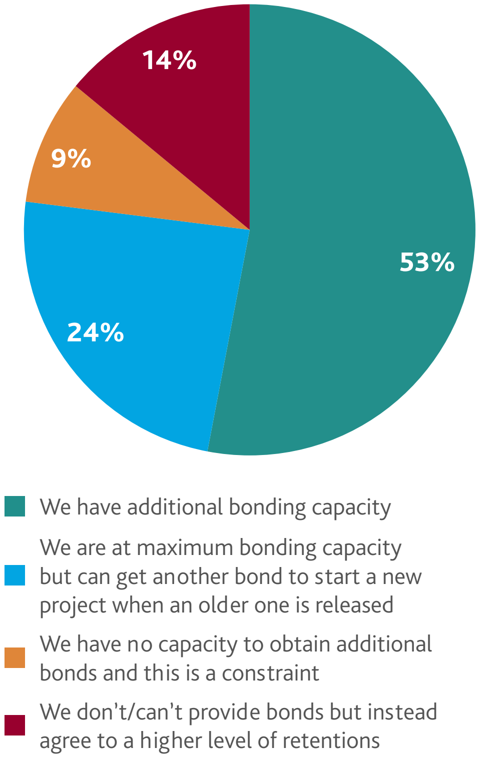
Cash Resources



ABILITY TO PROVIDE PERFORMANCE BONDS

INABILITY TO OBTAIN ADDITIONAL BONDS LIMITS GROWTH FOR MANY, BUT NOT FOR THE MAJORITY

Bonding Capacity



In 2018, 67% of respondents who needed to provide bonds believed they had additional or spare bonding capacity, 29% were at maximum capacity, and only 1 respondent said they had no capacity. This was both encouraging and surprising, as discussions with bankers indicated that obtaining bonds was a significant issue.

In the 2019 survey we added an additional question response; "We don't provide bonds but instead agree to a high level of retentions". This was a potential solution for those unable to obtain further bonding. If we include that category in with those that have no capacity to obtain additional performance bonds, we have moved from one company representing 4% of the relevant survey respondents being unable to provide bonding, up to 23% in 2019. We anticipated this trend last year but it did not come through in the survey responses. It is now clearly apparent.

Only 53% of survey respondents have spare bonding capacity compared to 67% last year. This demonstrates the further division in the sector between those that are financially robust and those with financial challenges.

While frustrating for those that are at maximum bonding capacity, this constraint is a useful mechanism to protect clients, head contractors and subcontractors from the adverse financial impact arising from over–trading.

For those still able to obtain bonding, we see greater caution and increased requirements from banks and other bond providers. Following several high-profile large insolvencies in the industry and the media attention on the sector's challenges, bond providers are seeking a greater level of security. They may require the shareholders of some companies to introduce further capital and they have significantly increased periodic reporting requirements. In some cases this goes as deep as reviewing the performance of individual contracts on a quarterly basis at a detailed level. These pressures further divide the sector between those financially capable and those financially vulnerable.

Due to poor margins, occasional projects running at a significant loss and the obligation to hold additional funds in trust for retentions payable, building financial capacity to provide security for bonding remains a challenge. Unless shareholders are willing to provide greater security to their bond provider, there is no rapid solution to this constraint.

Project delays have an impact. In some cases, a new bond cannot be issued and projects started until an existing bond has been terminated and released from the bond facility.

Companies that permit a higher level of retentions instead of bonding will likely have cash flow challenges. Invariably they will only be selected on projects where price is the sole determinant of who wins the job. As such, margins will be extremely tight.

This bonding challenge is one factor that will assist in driving margins up. But it will not be sufficient to deter those desperate to win a project at all costs.

THOSE WITH SPARE BONDING CAPACITY HAVE A COMPETITIVE ADVANTAGE

RETENTIONS INSPECTION

The retentions regime has been in place since April 2017. The regime places the onus for enforcement on those that have retentions deducted from their progress claims by giving them the ability to inspect trust records at any reasonable time.

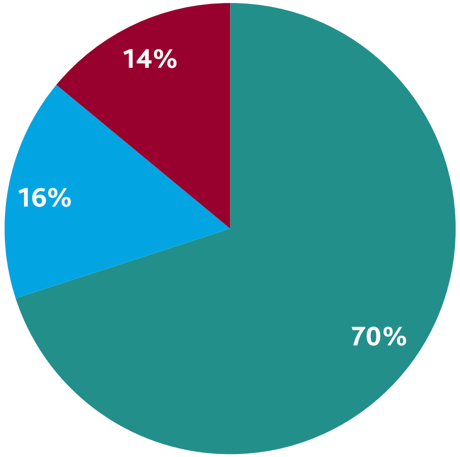
In our 2018 survey we asked how many check to see if their retentions receivables are held in trust by their customers. We were surprised by the level of inaction as, given most of the profit in a job is locked up in retentions receivable, this is basic risk management.

One year on, and despite a number of high profile insolvencies across the industry and shortfalls of funds in trust, we see little sign of improvement. In fact, the number of those actively inspecting their head contractor's trust records has only improved to 30% (+4% on last year). There appears to be no clear explanation as to why companies do not do this.

LESS THAN ONE THIRD OF RESPONDENTS INSPECT TO ENSURE THAT THEIR RETENTIONS RECEIVABLE ARE HELD IN TRUST

Most concerning, for those who did ask to inspect, almost half (47%) found at least one customer who was not holding funds in trust. This is up from 36% in our 2018 survey. These customers are simply not complying with the law.

Inspection Of Retentions Receivable Held In Trust



- We do not know as we have not asked our customers
- We have asked to inspect the records or enquired and it was satisfactory in every instance
- We have identified at least 1 customer who is not holdings funds in trust

COMPLIANCE WITH THE RETENTIONS REGIME

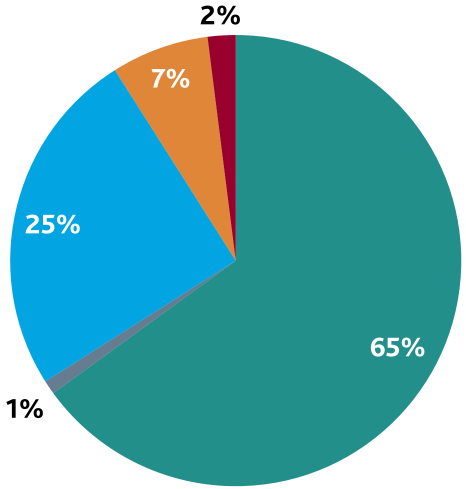
Our 2019 survey saw significant improvement in the number of those who say they fully comply. In 2018 only 72% of respondents who had retentions payable held these funds in trust, had an insurance policy, or used non-cash assets as security. In 2019 this has increased to 93% - a clear indication that this area of the Act is now better understood and compliance is improving. This is positive for the industry as, two years on from the commencement of the new regime, the majority of contracts should fall under the Act's new rules. Improved compliance may also help avoid the need for a more oppressive regime like the one introduced in Australia.

9 IN 10 ARE COMPLYING WITH THE REQUIREMENT TO HOLD FUNDS IN TRUST

The vast majority of respondents who have retentions payable (90%) use cash to comply with the Act. Of these, 72% are holding cash in a separate account in trust, with the remaining 28% having sufficient cash but not using a separate account. While the intermingling of funds is allowed under the Act, this is risky and does not guarantee that the funds are held in trust. Instead, best practice is to hold the retention monies in a specific trust account at the bank, for example labelled "XYZ Construction Retentions Trust Account". This ensures that in a receivership or liquidation situation it is very clear that the funds are held in trust and cannot be used for any other purpose.

The number of respondents who use an insurance policy rather than holding cash has fallen from 10% in 2018 to 1% in 2019. This is unsurprising, given the liquidation of CBL insurance in 2018 and the limited number of insurance companies that provide retentions insurance.

How Companies Are, Or Are Not, Complying With The Retentions Regime



- We are holding cash in trust
- We are using non cash assets as security
- We always have sufficient cash but are not using a separate account
- We prefer not to answer this
- We have a retentions insurance policy

ONE QUARTER OF THE INDUSTRY CAN STRENGTHEN ITS PRACTICES BY HOLDING FUNDS IN TRUST IN SEPARATE LABELLED ACCOUNTS

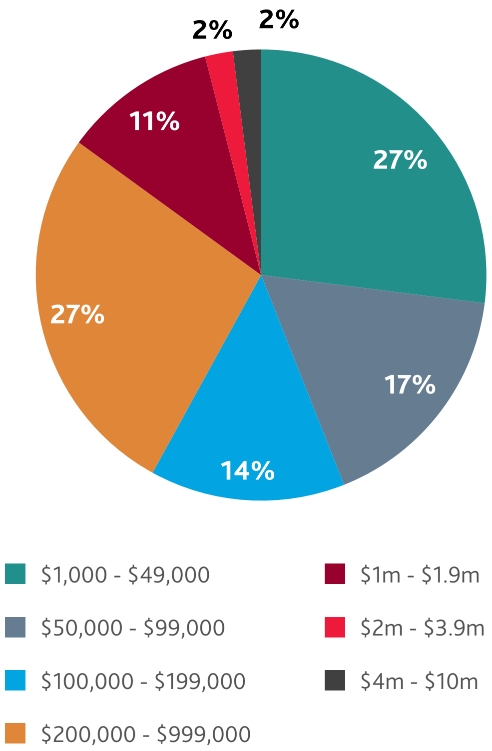
UNREASONABLE TRANSFER OF RISK

A defining feature between the current and previous construction cycle is the allocation of risk. Clients push as much of the risk down to the construction companies as possible, and these businesses, where they are able, try to push the risk further down to the subcontractors.

To determine the extent to which this is a real rather than a perceived problem, we asked the question, "How much do you estimate that unreasonable or inappropriate transfer of contractual risk has cost your business in the last year?". The focus of the question is on the word "unreasonable". We had 170 responses to this, and 60% did not identify any cost. An analysis of the remaining 40% is shown in the graph.

Many of those that did not show a cost noted they simply do not accept unreasonable risks - instead, they "tag out" or exclude risks they are not prepared to accept. Some noted they act in this way because of lessons learnt in the past. Often, arguments pertaining to risk play out in the dispute process - showing that this attitude to risk has clear links with contract disputes.

Cost Of Unreasonable Transfer Of Contractual Risk



DISPUTES

Construction, more than any other industry, has a reputation for very large disputes and unreasonable behaviour from a small minority. Tight margins and large monetary amounts are a factor in this. Nearly all recent large construction company collapses have been impacted or triggered by a substantial dispute.

The Construction Contracts Act has two important and relevant procedures:

- A defined process and defined timelines for the submission of a progress claim, the acceptance or modification of it with a payment certificate and payment within a clearly defined timeframe. The vast majority of transactions go through this process very efficiently and without difficulty, meaning cash flow management is usually relatively easy. Small matters or timing matters are frequently resolved through this process. There is often an attitude of trying to claim a little more than should be claimed, but this process eliminates most excessive demands.
- A formal disputes process which was recently upgraded to make it faster and easier to address a dispute. This covers most disputes, including faulty workmanship or materials, faulty design and determining the price to be paid for work where it is not agreed.

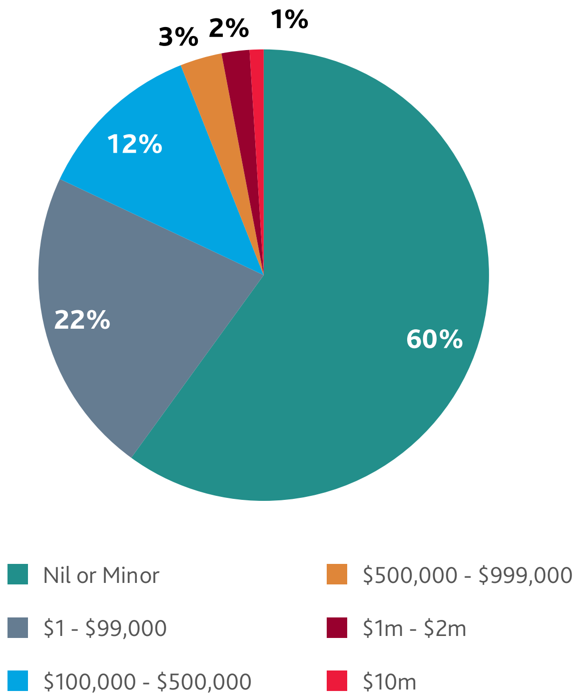
The disputes process does not prevent many of the unreasonable behaviours which occur in the sector where one party has completed work and expects to be paid and the other party attempts to manipulate the situation to avoid payment. This is common where the client does not have the funds or is unwilling to pay for additional things which come up during the construction process (referred to as variations and extras). Avoidance of payment also often occurs when the head contractor has a low margin and seeks to manipulate the situation to minimise their losses or improve the margin. Some of the tactics used during this process are outright bullying behaviour.

To attempt to quantify this, we asked the question, "How much do you estimate unreasonable contract disputes or unreasonable rejection of final payment claims cost your business in the last year? Do not include the normal range of reasonable negotiation." It is a matter of opinion and degree as to what is reasonable and what is unreasonable.

40% of the respondents have been impacted by unreasonable disputes and of those, 45% were for amounts over $100,000, and some in the millions.

As we have seen with the high profile collapses over the last couple of years, an unreasonable contract dispute has an immediate and massive impact on cash flow and can often be fatal to the business.

Frequency And Cost Of Unreasonable Contract Disputes

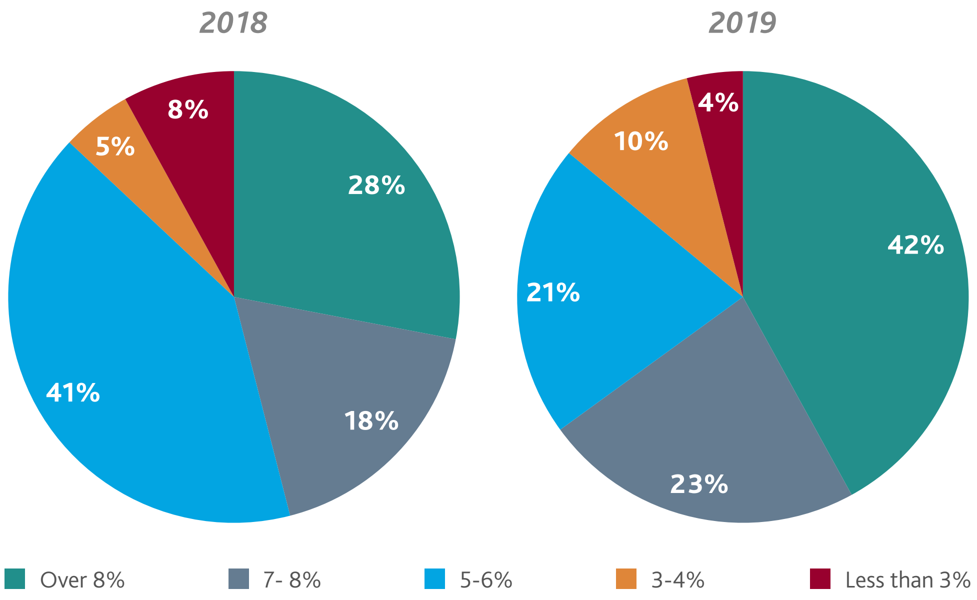


GROSS PROFIT MARGINS - HEAD CONTRACTORS

Margins have slightly improved but are still too low for a strong sector

We asked, "When competing for new projects, at what margin are you missing out on winning contracts?" The median moved to 7% this year over 5-6% last year. The majority missed out on projects on margins over 8%.

Level of margin that contracts are not won - All Head Contractors



While this improvement seems to be a step in the right direction, too many companies price low to secure work when they shouldn't. Their motivation may be altruistic, to ensure a continual flow of work comes through so that employees are kept occupied and there are no quiet patches. However, in most cases, this leads to working on low margin projects and cost overruns. Industry participants need to be more selective with the projects they choose to work on and not take on new work just for the sake of keeping busy.

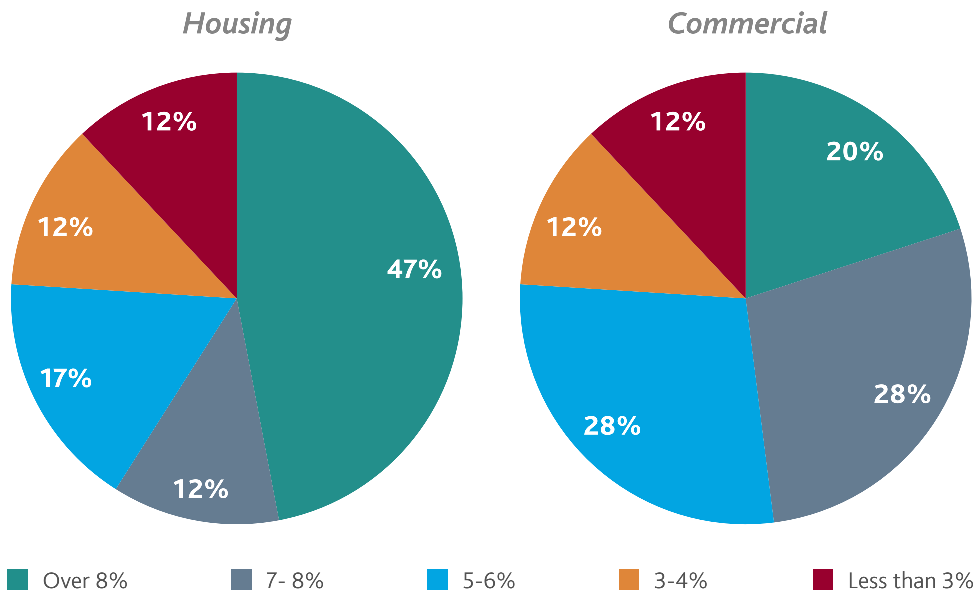
Those missing out on winning work at 4% or below are probably missing out for reasons unrelated to their contract price.

With the high profile insolvencies in the construction industry over the past 12 months we would expect clients to place less emphasis on price and more on working with reputable construction companies. As a result they are likely to be willing to pay more or accept a higher price to reduce their risk. This is already occurring, and as such, the gap is widening between long-established and reputable companies and those who seek to compete mainly on price.

Our survey asked participants to disclose their gross margins from the last financial year. The average gross margin for head contractors is between the 7% to 9% range, which is consistent with the trend seen above.

When we distinguished between Housing and Commercial, we saw the following trends:

Level Of Margin That Contracts Are Not Won By Sector - 2019

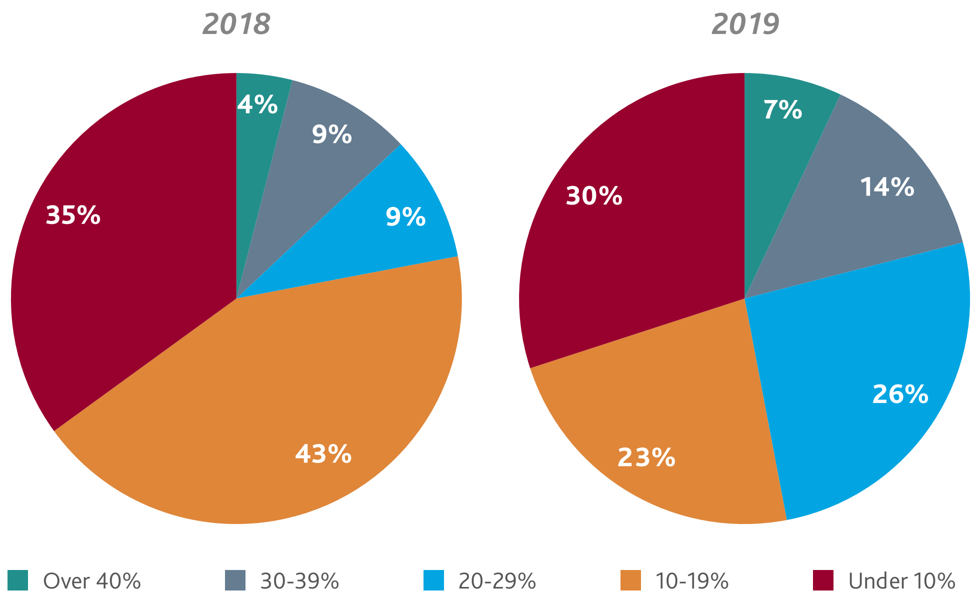


Margins in the housing sector (including apartments) are on average better than the commercial sector. This is likely to be due to the higher risk associated with each project and the different scale between the two sectors.

SUBCONTRACTORS' MARGINS ARE CURRENTLY TOO LOW AND STILL NOT SUSTAINABLE

To understand subcontractors' gross margins, we asked, "When competing for new projects, at what margin are you missing out on winning contracts?"

Level Of Margin That Subcontractors Are Missing Out On Projects



Half of the subcontractors surveyed are missing out on projects with under 10% or between 10-19% margin. While the percentage of respondents in these categories has reduced by 25% from last year, there are still too many subcontractors in the industry competing for projects at an unsustainable gross margin.

The more alarming trend shows that approximately one third of the subcontractors surveyed are still missing out on contracts at margins under 10%. Subcontractors generally have a lower turnover and higher overhead proportion compared to a head contractor, and thus need to operate with higher margins to recover these expenses and be profitable. The low margins expose a major vulnerability for these companies.

We asked our survey participants to disclose their gross margin percentage from the last financial year. The average gross margin percentage for subcontractors is in the 16-20% range which is consistent with the trends mentioned above.

The gross margins for subcontractors in Auckland are on average higher than the rest of New Zealand. While the reason for this is unclear, Auckland has a greater level of forward work and perhaps less need for desperate pricing.

Similar to last year, the shortage of quality staff, high compliance requirements and difficulty in controlling costs due to price increases are likely to adversely impact subcontractor margins.

Put simply, there is too much emphasis in New Zealand on price. High price competition between head contractors in order to improve their own margins and profitability places similar pressure onto subcontractors. This contributes to the price competition culture amongst subcontractors.

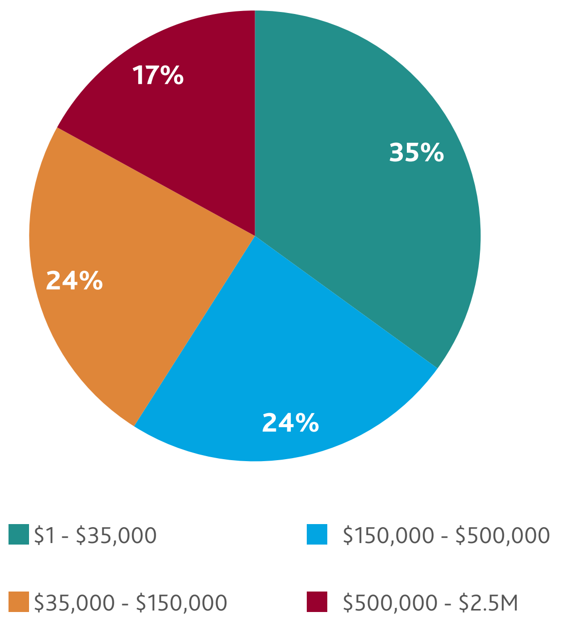
PROTECTING SUBCONTRACTORS

A very strong theme emerging from both the 2018 and 2019 surveys is both the vulnerability and critical importance of subcontractors. The sector is under-resourced and relies very heavily on subcontractors - if they suffer, the whole sector does. Despite this, some participants in the sector put too much risk and too much pressure on subcontractors, which then causes them to fail.

In addition to the financial stress put on employees and creditors, the financial failure of a subcontractor can have a profound effect on the head contractor and projects it has been working on due to non-completion of current and planned work by the subcontractor.

In the 2019 survey we sought data to attempt to understand the frequency and scale of the failures. The question was “In the past 12 months how much, approximately, has failure of subcontractors or has bad debts from clients/head contractors cost your business?” Of those that answered this question, 40% experienced some loss. Of these, 13 respondents had losses between $500,000 and $2.5M. Many businesses do not have the financial reserves to withstand pressures of this magnitude.

Quantum Of Losses From Subcontractor Failure And Bad Debts



THE MESSAGE IS CLEAR; THE INDUSTRY MUST SPEND MORE TIME AND EFFORT PROTECTING SUBCONTRACTORS. THE RISK OF A DOMINO EFFECT IS TOO GREAT

Subcontractor failure can occur through both external or internal causes.

The main external causes include:

- A large bad debt from a failed head contractor
- Inappropriate transfer of risk
- Delayed and rushed projects (where any planned efficiencies are lost)
- Disputes and delayed payments

However it is not a one-way street. Subcontractors need to understand internal causes and operate in a business-like manner by creating robust and reliable costing systems, not overcommitting, and managing cash flow and staff effectively.

Common causes and factors associated with subcontractor failure include:

- A lack of diversification with overreliance on one or two key customers
- Poor pricing or committing to projects that are not profitable
- Poor cash flow management including poor follow-up of overdue debtors
- Failing to properly manage variations
- Too much rework

MANAGEMENT REPORTING FREQUENCY AND QUALITY

The construction industry is complex but keeping track of performance shouldn't be. However, only 57% confirm they receive regular management reports that accurately measure profit as part of a more detailed set of reports.

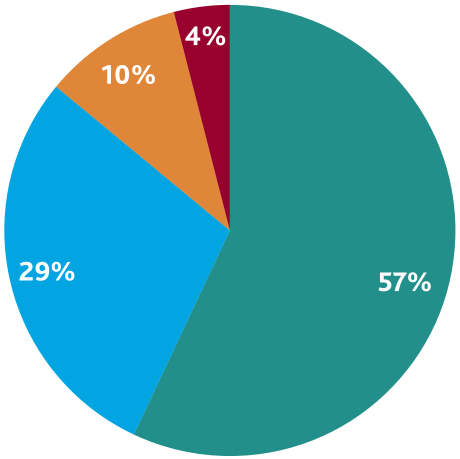
43% OF RESPONDENTS FIND THEIR REPORTING TO BE LIMITED OR LACKING

The remainder (43%) are challenged by limited information - in terms of both frequency and quality. The most common challenges are accurate measurement of stock, work in progress, income in advance or correct treatment of retentions. These are critical to understanding profit.

Best practice is monthly reporting and for larger companies a detailed board report covering a number of critical financial and non-financial areas in their business. This type of reporting gives business owners confidence over their business' performance and enables them to effectively plan for the future.

Frequency And Quality Of Reporting

- Obtain regular and accurate management reporting as part of a more detailed set of reports
- Limited frequency but accurate reporting
- Inaccurate or irregular reporting
- Regular but unreliable reporting



Key opportunities:

- 14% of respondents could get a better gauge of their performance by improving the frequency and quality of the reporting they receive
- 43% of respondents are likely missing out on opportunities to improve their business' performance as a result of limited information

GIVEN THE PRESSURE ON MARGINS, ACCURATE REPORTING IS A FUNDAMENTAL PREREQUISITE FOR SOUND MANAGEMENT AND SPECIALIST INDUSTRY ADVICE IS AVAILABLE.

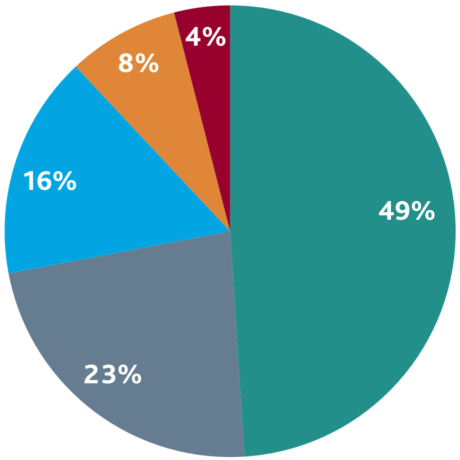
TAKE IMMEDIATE ACTION TO ACHIEVE POSITIVE CHANGES FOR IMPROVING REPORTING.

BENCHMARKING

BDO provides a benchmarking service to our clients covering a wide range of industry-specific ratios. Directors find this and the in-depth discussions around it invaluable as it focuses on the parts of the business and balance sheet where improvements can be made. Because BDO understands the companies which form the data set, we are able to provide particularly insightful advice whilst also preserving confidentiality.

STAFF

Staff Vacancies 2019



- Current staff levels meet our needs
- We are actively looking for additional on-site staff only
- We are actively looking for additional on-site and office based staff
- We are actively looking for additional office based staff only
- We are currently overstaffed

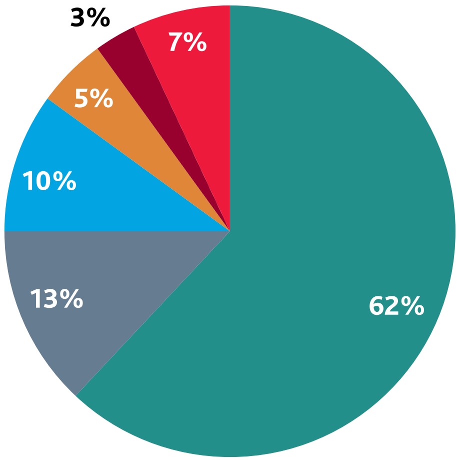
82% of respondents, when listing their concerns, said the greatest challenge or concern in the industry is unavailability of skilled labour.

47% of those surveyed are still actively looking for staff, with a majority of them looking for onsite labour. While this has reduced from 69% last year, the skilled labour gap is still very much prevalent and forms a key issue in the construction sector.

Similar to last year, those who are using recruitment agencies have less of a challenge in meeting their staffing needs. However, most still prefer not to pay recruitment fees and are using word of mouth or their own advertising as the principal source to procure new staff.

Comparable to last year, the number of businesses sourcing new staff from colleges and/or universities is still low. The likely reasons for this are the lack of technical skills and/or on site experience.

Principal Source Of Staff



- Word of mouth/advertising
- Agencies
- Overseas
- Poaching
- Colleges/Universities
- Other

Many in the survey have also expressed their concerns surrounding the younger generation lacking the necessary level of professionalism, pride and motivation that would be reasonably expected from them.

This skills shortage is a lot more prevalent in Auckland when compared to the rest of New Zealand. As a result, companies in Auckland need to pay more to procure quality workers.

The Government forecasts that the construction industry will need an extra 50,000 workers by 2022. To bridge this current and future skilled labour gap the Government has recently agreed on a new construction sector accord. This commits to increasing investment to provide more training and apprenticeship opportunities, and to ease the immigration standards for skilled labour in the construction sector in the short to medium term. It will be interesting to see the detail and ultimately the specific actions and effectiveness of these promises.

SUCCESSION PLANNING

48% OF RESPONDENTS OVER 50 STILL NEEDED TO CONSIDER SUCCESSION OR EXIT PLANNING

Due to the relative ease in setting up a new business and the perceived low barriers to entry, it can be very difficult to sell an entity outright. As a result, there are inherent challenges in finding a ready-made purchaser who is willing to pay a price and purchase at terms that sufficiently reward the departing business owners for the number of years they have spent developing and growing their businesses to its established stage. When a suitable person is found, they may not have sufficient funds and may struggle to raise the necessary finance.

A well-established succession plan helps alleviate the challenges mentioned above. It allows the departing owner to have more of a say and phase their exit on their own terms. It also helps ensure that the business they have built and spent a large portion of their life establishing continues to operate after they leave.

Succession and exit planning is a journey and not an event. It takes a number of years to identify the appropriate people and then successfully implement.

Prior to the global financial crisis (GFC), there were many succession plans being implemented and business sales taking place. After the GFC, business sales in the construction sector virtually ceased and succession plans were more challenging due to poor financial results. When the current industry cycle does take a downturn, a similar trend is likely to occur. Those that have not planned their succession or exit during these good times will find it challenging. They may struggle or have to close their business down altogether.

The other theme we notice is that businesses with well-established succession and exit plans offer their key management-level employees (those who have potential to be a future owner) a minor shareholding in the company. This strategy helps the businesses retain quality staff and makes it more difficult for them to be poached by competitors.

At BDO, we have undertaken and assisted many businesses in this sector with the successful establishment and implementation of their succession and exit plans. We have tailored exit strategies and succession plans to meet the unique needs and wants of each business and their owners.

START PLANNING EARLY: TAKE SOME ADVICE ON YOUR LIKELY OPTIONS

SHAREHOLDER AGREEMENTS

26% OF THE COMPANIES FROM OUR SURVEY WITH SEVERAL UNRELATED SHAREHOLDERS DO NOT HAVE A SHAREHOLDER AGREEMENT IN PLACE OR HAVE A SHAREHOLDER AGREEMENT IN PLACE WHICH IS NOT COMPREHENSIVE AND IS OUT OF DATE

A high quality shareholder agreement sets some ground rules, protections and processes for resolving issues such as when a shareholder is sick or dies, as well as various other events, crises and disputes. In many cases a comprehensive agreement provides a cost-effective mechanism to achieve a solution to a dispute and/or issue. The provisions of the Companies Act are frequently unhelpful in the absence of a shareholder agreement. It is highly recommended and good governance practice to have a comprehensive and up-to-date shareholder agreement in place, particularly for companies with unrelated shareholders.

The high number of respondents that do have a comprehensive and up-to-date shareholder agreement in place is encouraging. However has your agreement been tested at a time of stress? We would recommend that these agreements be reviewed by Advisers with specific industry experience every 4 to 5 years and at the time of a major shareholding change. This will ensure agreements are still relevant under the current structure of the company, and the ever-changing external environment that the business operates in.

The BDO construction team has prepared, as well as reviewed, many shareholder agreements for businesses in the construction sector. We have developed a number of innovative clauses for head and subcontractors. These aim to better meet the dynamics of the sector - as well as the specific culture and issues of each client - than generic shareholder agreements.

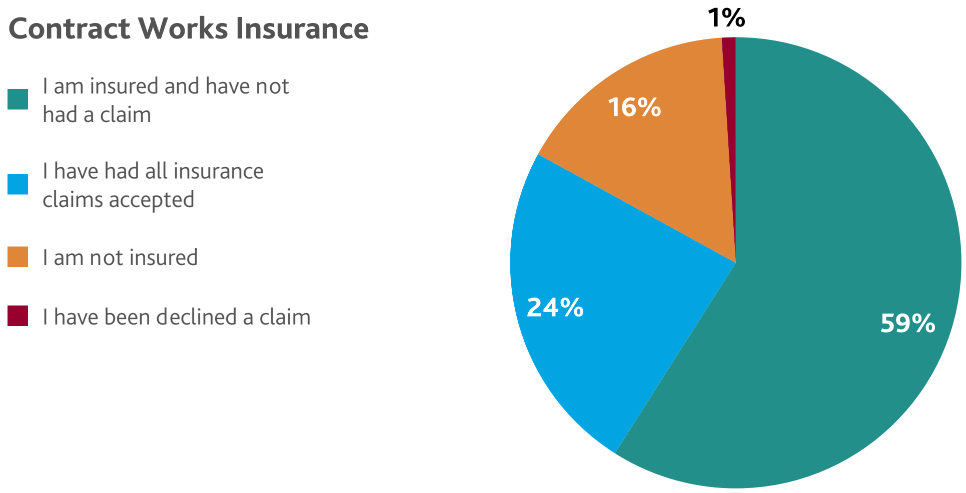
INSURANCE

In addition to active daily risk management of all aspects of a business, insurance forms a critical component of the total risk management strategy. Insurance costs are currently on the rise after a number of years with minimal increases or even reductions (on a like-for-like basis). There has also been an increase in claims from the sector as a whole. Changing risk profiles (i.e. the business grows), more policies (such as cyber) and increased limits are adding to insurance costs.

Contract Works Insurance

One of the key policies is Contract Works Insurance, which provides cover for physical loss or damage to "the Works" being undertaken. The policy then pays to reinstate "the Works" to their condition immediately prior to the event. This insurance includes the Principal and Main Contractor as Insureds. At present insurers are closely monitoring the extent of cover and are looking at imposing restrictions or removing cover.

Contract Works Insurance



Of those who are insured, 29% have had a claim and had it accepted. Whilst this is not for a single year, it suggests the frequency of insurance claims is relatively high. It is therefore a little surprising that 16% of respondents advised they were not insured unless they are covered under a single project contract works policy – which worryingly they are unaware of. A small number of those who do not have Contract Works Insurance are in allied fields where it is not required, but this does not account for the majority of those who choose not to insure or skipped the question. The key takeaway for industry participants is to check that you have contract works insurance on all of your projects. You should also ensure that clients and suppliers have appropriate insurance - if they say they do, ask to see evidence of this.

Directors' and Officers' Liability Insurance

This insurance covers directors and officers against liability they might incur in carrying out the duties of a company director or officer. The insurance will also reimburse the company where it has already indemnified its directors for any such liability. Cover includes associated defence costs.

Historically there have been relatively few claims for this type of insurance and it has been readily available to most directors. The landscape has now changed. The recent judgement from the High Court in the Mainzeal case (which was appealed by the directors and cross-appealed by the liquidators who brought the claim) awarded Mainzeal $36m from the directors. This has changed the attitudes of insurers and will have a significant impact upon terms and who can actually obtain insurance. Another issue is how costs and liability is shared between directors.

One immediate response from the insurance companies, other than increasing premiums, is to seek the disclosure of financial statements and full financial information.

Participants in the construction sector have historically kept their financial results and financial position a closely guarded secret. We asked whether participants are prepared to have the full financial information disclosed to the insurer so that they can get directors' and officers' liability insurance. Three quarters were happy to provide the financial information but 25% were unwilling to provide the information.

The consequence is that there will be a significant number of directors in the sector who may not have directors' and officers' liability insurance. The risk they run is adverse legal proceedings, which of course has high associated costs, as well as the potential for personal exposure or even bankruptcy. This emphasises the importance of appropriate directors' and officers' liability insurance.

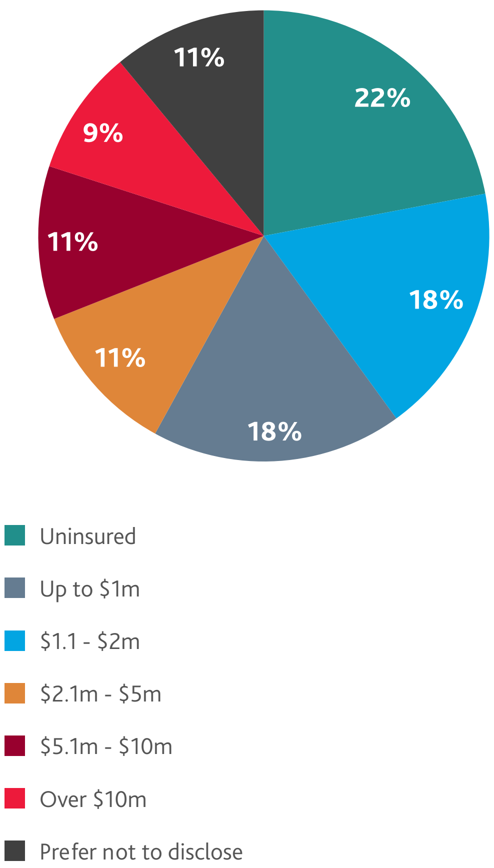
Based on the Mainzeal judgement, consideration needs to be given to whether your Limit of Indemnity is sufficient. A directors' and officers' insurance policy insures the indemnity but also provides cover for legal defence costs to defend any action against the directors and officers that falls within the scope of the insurance policy.

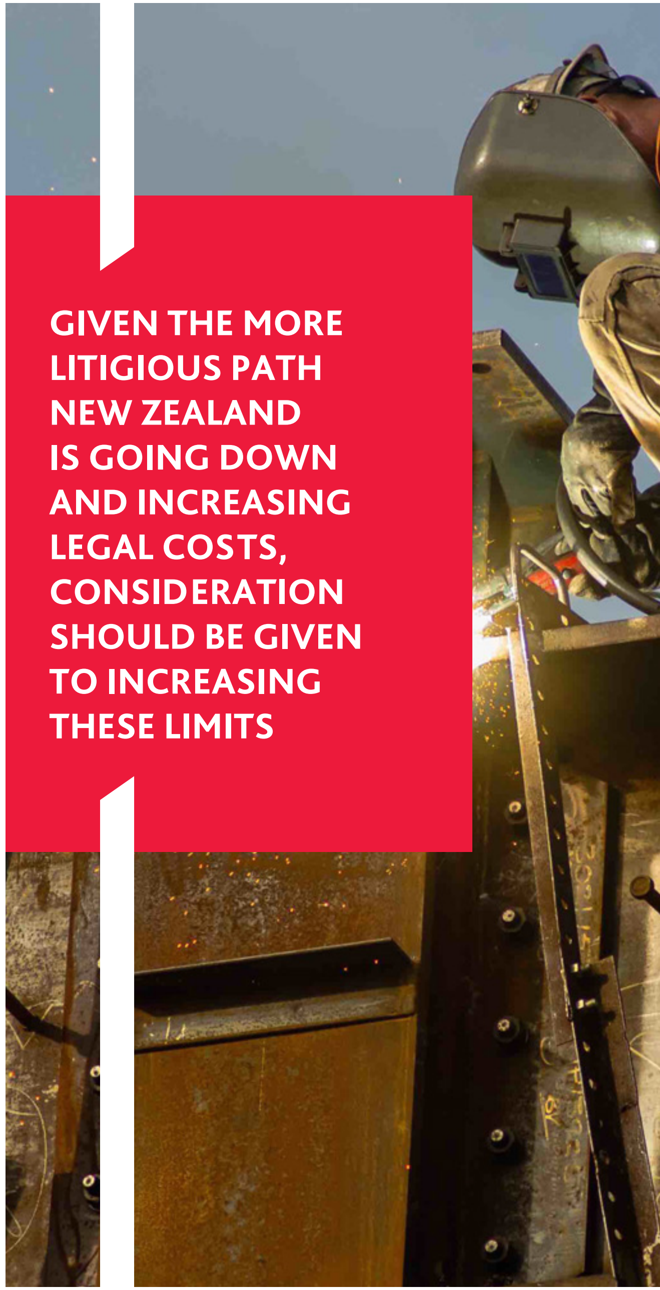
One of the findings in the Mainzeal case was that the directors continued trading in an insolvent state for much longer than they should have. The lesson for directors is the importance of seeking appropriate financial and legal advice and acting on that advice appropriately.

The limit of indemnity of directors' and officers' liability insurance varies significantly as does the size and risk profile of the companies that have insurance.

58% of respondents are either uninsured or have $2m or less of directors' and officers' cover.

Directors' And Officers' Liability Insurance Coverage





GIVEN THE MORE LITIGIOUS PATH NEW ZEALAND IS GOING DOWN AND INCREASING LEGAL COSTS, CONSIDERATION SHOULD BE GIVEN TO INCREASING THESE LIMITS

SUSTAINABILITY FOCUS

Sustainability is becoming more frequently discussed around boardroom tables and is being driven by the younger generation and some government departments. It means different things to different people in different circumstances and can therefore be challenging to objectively measure.

For example, sustainability can refer to:

- Waste minimisation
- Financial sustainability
- Workforce sustainability
- Environmental sustainability
- Training sustainability
- Efficiency
- Design features and material componentry choice

When asked whether procedures have changed significantly to more sustainable practices and how, a number of recurring themes and comments emerged:

Five participants referred to home star ratings

WE ARE CURRENTLY POSITIONING OURSELVES IN THE ECO-BUILDERS MARKET, BUILDING HOME STAR RATED SUSTAINABLE HOUSING. IT'S BEEN A SLOW UPTAKE BY CLIENTS WHO SEE THE ADDED INITIAL INPUT AS WASTED, PREFERRING TO SPEND ON LARGER FLOOR PLANS OR UPGRADED FITTINGS

The most common responses where action is being taken related to waste handling and recycling of building materials.

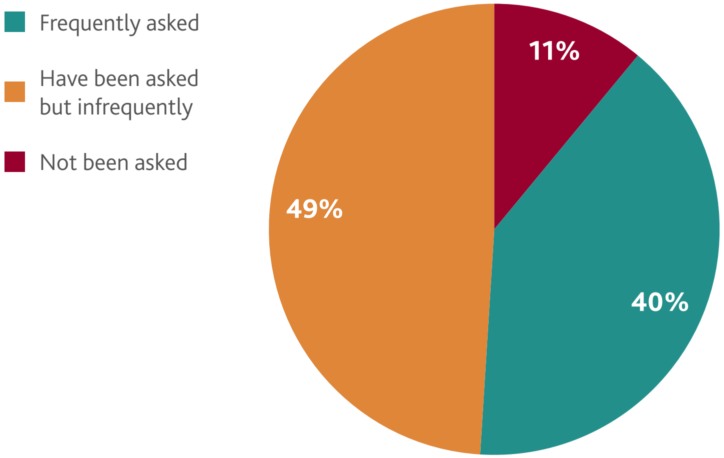
CLIENTS THAT ASK FOR "GREEN BUILDINGS" ARE QUITE OFTEN THE ONES THAT WANT TO REDUCE COSTS. CONSEQUENTLY SUSTAINABLE PRACTICES ARE THE FIRST THING TO GO

The most common responses emphasise that minimising cost is a much greater focus than sustainability. This led to scepticism that lowest price was more important than sustainability where sustainability was a specific criteria in the tender or client acceptance process.

DEVELOPER CLIENTS ARE ONLY INTERESTED IN THE LOWEST PRICE AS THEY WILL BE SELLING THE BUILDING. ANY SUGGESTION OF THE OPPOSITE IS DISINGENUOUS

We asked "When you have provided quotes to prospective clients or responded to tenders, have you been asked to provide details of your sustainable practices?" The results were as follows:

Provision Of Details Of Sustainable Practices



Cost considerations consistently override sustainability considerations

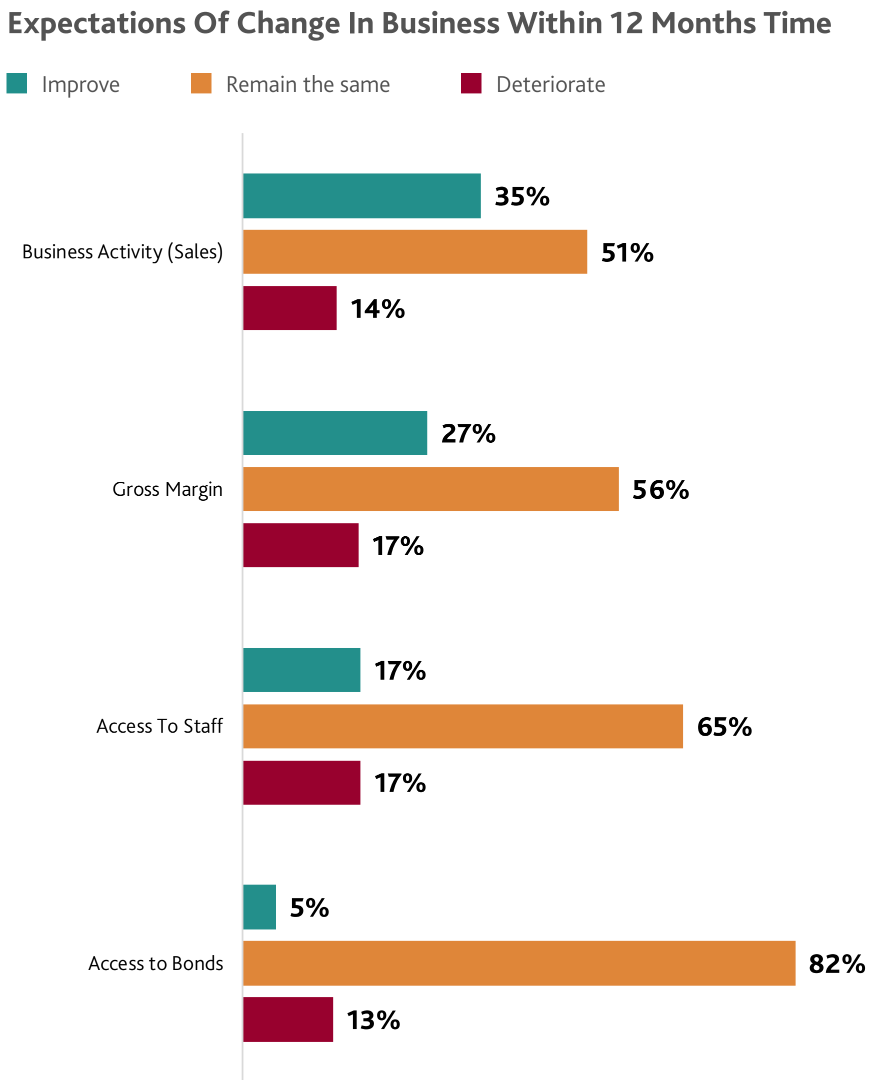
In discussions with our own clients, the relatively high cost of labour means the efficient use of offcuts or removing nails and reusing pieces of timber is not economical. It is cheaper to put these things in the rubbish skip and use a new piece of timber or plasterboard etc.

Whilst there is clearly an opportunity to reduce and recycle waste there are potentially larger gains to be achieved by increased productivity, efficiency and more efficient allocation of resources within the sector.

FUTURE OUTLOOK

Most people expect activity and conditions to remain similar but with slight optimism for business growth. There are only limited expectations of improvement in margins.

Bonding capacity is already a real issue and while most expect this to remain similar, our belief is that it will become more challenging and continue to constrain those that lack real balance sheet strength.



THE TEAM

JAMES MACQUEEN

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Qualifications

Chartered Accountant (B.Com)

Member of NZIOB

Member of NZ Society of Construction Law

Executive Summary

With more than 40 years of advisory, business services, tax, corporate finance and audit experience, James maintains a proactive partnership approach with his clients who benefit from his multi-disciplinary range of services and experience across a wide range of industries.

James passions include construction, manufacturing and family business. He has great insight into the issues and challenges facing these sectors. James develops a very close relationship with his clients and provides practical and pragmatic advice. His clients appreciate his strong industry expertise and look to him for leadership in emerging issues.

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Qualifications

Chartered Accountant (B.Com, LLB)

Executive Summary

Nick is an Advisory Associate in BDO's East Tamaki office where he works closely with James MacQueen. He works with a range of clients in a wide variety of businesses, including property, construction & family businesses. Nick is involved with corporate finance transactions, valuations and general business advisory work.

Nick has more than thirteen years' business services, audit, business recovery and restructuring and commercial experience in New Zealand and overseas.

Nick worked for BHP Billiton, the largest company in Australasia in various finance roles for three and a half years working in London, Johannesburg, Melbourne and Brisbane before settling in Sydney with the company. He returned to Auckland in 2013, joining BDO to focus on construction and corporate finance.

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WHANGAREI

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