Market analysis

Evolutionary theory

The changing subcontractor landscape in the Gulf region

JAIVIME EVARISTO, BUSINESS ADVISORY PRACTICE, CONSULTANT, CONTAX PARTNERS

With 8 years of consulting and research experience, Jaivime is a consultant in the Business Advisory Practice at Contax Partners. He has worked with globally renowned companies such as GlaxoSmithKline. In addition to his FMCG experience, he has a strong background in the energy, utilities, construction sectors within the Middle East.

2009 marked the bicentenary celebration of the birth of English naturalist, Charles Robert Darwin, who postulated that: *It is not the strongest of the species that survives... nor the most intelligent that survives. It is the one that is the most adaptable to change.* As with many great 19th century thinkers, perhaps, Darwin too did not expect that his works would transcend the boundaries of natural science and seep deep into the crevices of economics. At no point in recent times can this be seen more evident than the impact of the Great 2008-2009 Recession to businesses and their struggles for survival.

In the GCC hydrocarbon sector, for example, the impact of c.US$30-35bn worth of capital projects that have been cancelled or put on hold following the crisis, which was severely felt in Q3/Q4 2008, cannot be overstated. Aggravated by cash flow constraints that seem to worsen as one goes down the EPC value chain, the 80/20 principle could in no circumstance be neglected. The emphasis grows more profoundly especially in small and medium-sized contractors who by nature need to defend themselves from bad debts by expanding their customer base and thus reduce dependence on limited sector clientele. Hence, in recent months we have seen market trends where traditional subcontractors have carefully extended their wings into relatively new disciplines and functions by employing either vertical (inter-functional) or horizontal (inter-disciplinary) integration strategies.

Inter-functional Integration

Specialty discipline contractors such as Kentz and Larsen & Toubro (L&T) have recently proved themselves highly capable of carrying out full EPC projects. With project values in the range of US$50-250mn, Kentz and L&T appear well positioned to capitalize on their in-house engineering capabilities in the execution of relatively small-sized EPC projects. The value proposition for the project owner is straightforward and simple: reduce the client-contractor interface complexity and risk through a single-point EPC responsibility. Conversely, the contractors benefit from the approach as it enables them to capture more of the pie and move up the value chain by building their full EPC capabilities albeit on a relatively more specialised and smaller scale.

The timing for a single-point responsibility value proposition appears most suitable in the conditions that have shaped the GCC Capex market in the last 14

$79bn

Current Saudi Arabian private sector investment in energy projects.

Source: www.sagia.gov.sa

Contractors are meeting the new challenges by employing vertical or horizontal integration strategies.

15%

GCC operations and maintenance market is expected growth 15% each year to US$17.7bn by 2014 - more than double its current level of $8.8bn. Source: Contax Partners

months. On a business development level, whilst both Kentz and L&T have shown great strides in fortifying their respective full EPC capabilities, the performance to date suggests that neither has a "strike anywhere" approach. In fact, the strategic intent of their business development efforts looks clear: Kentz wishes to carve a niche in specialist EPC services for onshore modular production, turnkey temporary and O&U facilities with focus in upstream oil and gas sectors; L&T, on the other hand, looks bent on maximizing the economies of scale in the execution of power sector projects, particularly substations and transmission lines.

Similarly, other contractors have expanded further downstream in the vertical value chain of industrial facility development, particularly in the area of Operations and Maintenance (O&M). Contax Partners has long communicated that the next growth market for contractors in the GCC will be in the operations and maintenance of existing and future oil and gas assets. It is estimated that the GCC O&M market will grow by a CAGR of 15% to c.US$17.7bn by 2014 from c.US$8.8bn this year, driven largely by new assets in Saudi Arabia, the UAE and Qatar. To take advantage of this, we have recently seen the likes of Athens-based CCC forming a JV with UK's Wood Group covering the GCC and Yemen. In addition, Qatar's Black Cat early this year formed a joint venture with international engineering and project management company, AMEC, to offer local asset support services, still in the O&M sector. The growing attractiveness of the GCC O&M market to contractors is also reflected in project owner trends elsewhere worldwide.

Globally, recent results from a study conducted by US-based FMI entitled Inflection Point: Defining the Future of the Worldwide Construction Industry found a 30% increase in outsourcing O&M activities by project owners since 2006. The trend is more likely to increase further between now and 2014. Although the propensity to outsource O&M in the GCC varies largely by country and by project owner, potential opportunities are in no doubt up for grabs in the coming years. Local contractors with high quality resources on the ground, which are able to forge partnerships with well-

The multi billion dollar petrochemical projects in Abu Dhabi have attracted international contractors.

reputed international service providers, will no doubt lead the pack within the upcoming GCC O&M market.

Inter-disciplinary Integration

Although not all contractors have the capability of integrating vertical functions such as engineering, procurement, construction, operations and maintenance quickly, others are pursuing horizontal expansion and integration by developing new capabilities across disciplines. Some contractors specialized in mechanical installation and fabrication have recently expanded into offshore marine and E&I. Conversely, others that are traditionally focused in E&I are now considering expanding its mechanical and piping capabilities to complement the existing suite of E&I services.

Moreover, other contractors that used to subcontract non-core disciplines out are now considering carrying out multi-discipline activities in-house either through "synergies" with respective contractors that belong to the same holding company or investing in assets that, on a more long-term scale, provides the basis for further integration.

These trends support the level of innovation that firms are undertaking in the hope of achieving economies of scope and improved market power over competitors.

Local contractors with high quality resources on the ground need to join forces with foreign partners.

"The only thing constant is change"

Firms resort to a myriad of combinations in trying to maximize the value of horizontal and vertical integration. Some streamline their focus to gain superior advantage in a given niche while others broaden their portfolio to spread risks more evenly and enhance their bottomline from different revenue streams. Whichever route a firm decides to take, its ability to acquire critical market information, identify scenarios and analyse the implications of each option, formulate strategies and value propositions that are aligned to the customer needs and and execute tactical and strategic plans flawlessly with a high degree of flexibility could well stand the practical definition of business adaptation, specifically in the context of the ever changing EPC market in the GCC.

Whether the aforementioned contractor trends will shape the future of the prevailing projects market in the GCC, or if the market is only responding to the needs of the times, is a worthy topic of debate. Whichever market force comes first, it is clear that what remains pragmatically compelling is the fact of nature which favours those that are "adaptable to change". PME

Operations and maintenance outsourcing by project owners has increased 30% since 2006.

To further discuss how the Contax Partners' Business Advisory Team can help you fully understand the current subcontracting environment and support you in planning for and executing your Capex projects successfully, please contact Ann-Marie Carbery at AnnMarie.Carbery@contaxpartners.com.