Tender Cost Update
MENA H2 2018

A PERFECT STORM OF CONSTRUCTION GROWTH DRIVERS DOES NOT GUARANTEE STABLE AND SUSTAINABLE GROWTH IN THE MENA MARKET

A combination of event driven activity, diversification efforts, oil driven economic recovery and structural demand for basic needs infrastructure, is set to make MENA the most attractive construction market globally over the next decade.

Dubai and Qatar are seeing continuing high levels of investment due to their respective large scale events which are driving construction demand. The price of oil is growing, allowing battered economies the breathing space to stimulate private demand for housing, retail and commercial space. Investments to diversify the economy are continuing to drive project work as new foundations are built for Middle Eastern economies. And finally, the growing and increasingly urban populations of these countries are beginning to demand the level of services provided to citizens elsewhere, requiring further government investment into social and transport infrastructure, utilities and energy construction. All of these are driving the market to activity levels unseen since before the financial crisis. However, the recent real estate slowdowns in Dubai and Abu Dhabi, economic woes in Saudi Arabia and embargo in Qatar are impacting on the fortunes of the region's biggest construction markets, creating difficulties in securing and starting projects.

"Tier 1 multinational contractors are exiting this challenging market due to cash flow issues at the same time as oil price growth loosens fiscal conditions in some countries. This is allowing project activity to ramp back up in previously depressed markets such as Saudi Arabia. With lower levels of capacity available in the market, and strong demand from diverse drivers, it is a supplier's market which could ultimately drive up tender prices."

Mark Taylor, Regional Director, MENA

The MENA construction market will see the strongest growth globally over the next decade at...

6.2%

annually as full project pipelines are executed.

Oil prices have jumped from...

allowing more project contracts to be awarded as austerity eases.

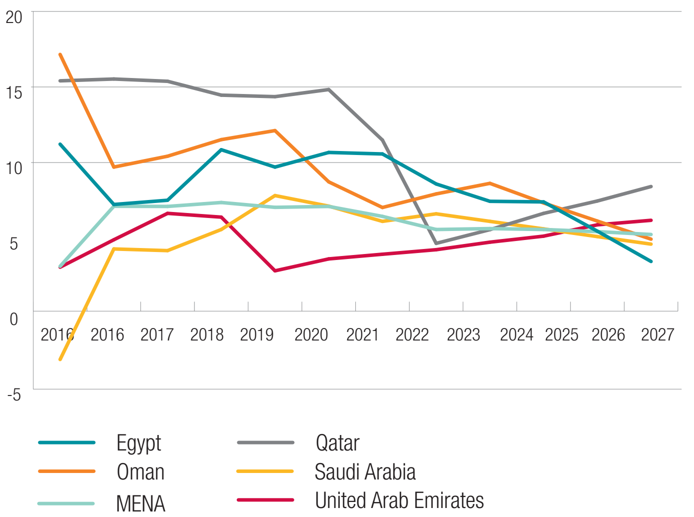
Qatar is set to be the regional star performer, with...

15.4%

construction output growth forecast in 2018 – more than twice the regional average.

CONSTRUCTION MARKET

Construction Gross Value Added % Annual Growth - BMI



Despite the evident challenges, the MENA construction market will be the most attractive region globally for the construction industry over the next five years. It will be driven by the significant project related activity in Dubai and Qatar, and renewed funding of projects in Saudi Arabia. On top of large scale event driven activity, the efforts to diversify economies across the region are resulting in investments across the commercial, retail, industrial and hospitality sectors as countries develop sectors outside of oil and gas. The region's construction added value will grow 6.2% annually to 2027, a strong pace of growth which belies mixed fortunes within, based on relative success at diversification. Despite the region's numerous star markets, such as Egypt, Qatar, and in the near future Saudi Arabia, there are many laggards dragging down the positive outlook through a myriad of security risks (such as in Libya and Yemen). With construction activity set to boom across the region we expect tender prices to rise as the pace of activity picks back up and contractors regain market power. The tight market is already allowing prices to creep up in the supply chain which is resulting in upwards pressure on tender prices.

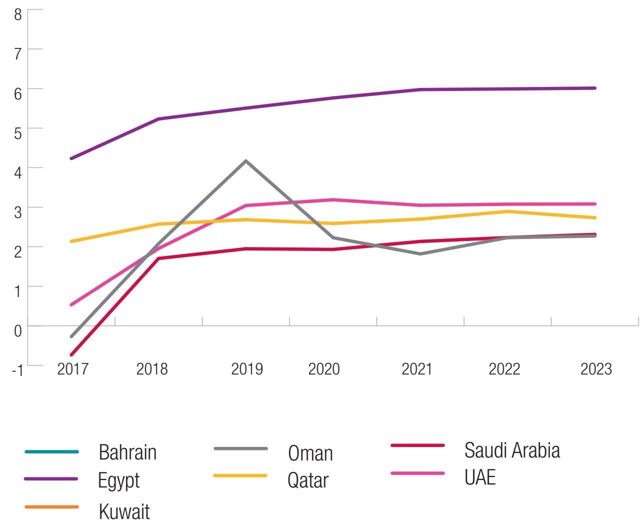
Behind the upward pressure on tender prices there are also some fundamental shifts in how suppliers come to market. Previously Tier 1 contractors took up the bulk of work in the region, keeping large labour pools and deploying when necessary. This has shifted to subcontracting labour, with Tier 1s slimming down. Part of this derives from the exit from the market by many multinational (often British) contractors, and the slimming down of those which remain. Driven by cash flow issues this exodus has resulted in significant loss of skill, especially at the Tier 1 level. As labour capacity diminishes labour costs are growing, and the practice of subcontracting labour is also putting upward pressure on tender prices.

COSTS

The rapid growth across construction markets in the MENA region is swelling prices of building materials and labour as an increasingly large pool of projects chases a finite amount of suppliers and skills. Add to that the disruptive effects of the Qatar embargo, recent appreciations in MENA currencies, and the ongoing reliance on skilled and unskilled migrant labour and we have a perfect storm of cost pressures. With anticipated average inflation rates around 3-5% for consumer prices, and cuts to subsidies increasing project spending to once again climb to historic levels.

ECONOMICS

Annual GDP growth - IMF



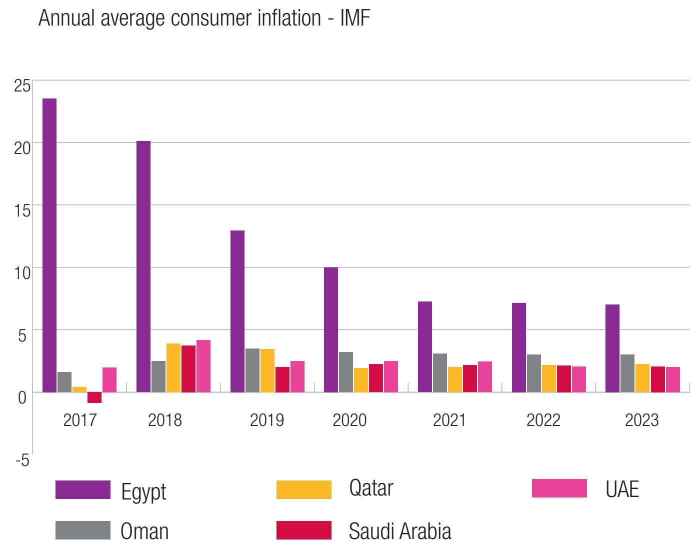
Economic growth in the MENA region over the next five years will range from Oman and Saudi Arabia's meagre 2.1% annual increase through to Egypt's booming 5.9%. But across these disparate fortunes we see a very similar trend in the governments' policies and visions. All have, to varying degrees, recognised that oil will no longer be the driver of their long-term economic fortunes, and all are enacting policies to prepare them for this. This focus on economic diversification through investment in non-oil sectors will be one of the fundamental drivers of the MENA region's leading position in the global construction markets.

Brent Crude Oil is forecast to average USD73/bbl in 2018 (up from USD54.7/bbl in 2017) - a positive for fiscal revenues in the region, enabling countries like Saudi Arabia to ease off on the austerity which was harming their construction pipelines. As such, there is scope for project awards to see growth over the next year, providing further impetus to the construction industry and adding to pressure on tender prices. Additionally, economies reliant on oil will see stronger growth this year, resulting in more demand for residential, commercial and retail construction.

As well as diversification and growing economies the construction market in the MENA region will be pushed forward by a deeper force: the inherent structural demand for infrastructure from a population long under-invested in.

No longer able to maintain social and political satisfaction through oil-revenue payouts, governments in the MENA region are increasingly looking to respond to the basic needs of their populations through investment in the construction of housing, health, education, transport and utility facilities.

INFLATION



Inflation will spike this year in many MENA countries as fiscal measures to increase revenues, such as the introduction of VAT and elimination of subsidies on energy, begin to bite, feeding through to consumer and producer prices. After the relatively slow economic activity and consequently low price pressures of 2017, this year is a different story, with a combination of rising oil and commodity prices impacting alongside fiscal measures and growing activity levels. This has resulted in inflation rates between 2.5% (Oman) and 4.2% (UAE) in the Middle East. Egypt is a case apart due to the large currency devaluation in 2016 which is still feeding through import prices, causing outsized inflation (20.1% in 2018) with a natural knock on effect on construction costs.

EXCHANGE RATES

COUNTRY	06 AUGUST 2018	MONTHLY APPRECIATION	YEARLY APPRECIATION
AED Emirati Dirham	4.2451	1.54%	1.86%
SAR Saudi Arabian Riyal	4.3347	1.54%	1.87%
EGP Egyptian Pound	20.6645	1.63%	1.53%
OMR Omani Rial	0.4444	1.55%	1.92%
QAR Qatari Royal	4.2075	1.54%	2.21%

As the US dollar has strengthened over the past year, the Middle Eastern currencies (Dirham, Riyal, Rial, and Royal) which are tied to the value of the dollar have strengthened in tandem. While this could be a boon in terms of lower costs of exports, in reality it’s a threat to the countries looking to present value for money to foreign investors, for whom investment will be made more expensive. Combined with ongoing challenges to securing financing in the region, any further strengthening in the dollar could be a challenge. And with the threat of trade wars hanging over the global economy and likely to push the dollar higher, this will continue to pose a challenge.

UNITED ARAB EMIRATES

There are many factors contributing to a positive outlook for the UAE’s pipeline, most notably the rising oil prices easing pressure on revenues, a growing global economy boosting receipts and ongoing demand for construction from the Expo 2020 event. GDP growth is forecast to expand rapidly over the course of the year to 2.8% in 2018 and 3.3% in 2019, compared to a meagre 0.7% in 2017. This growth, and the growing middle class in the country, will drive investment in residential and non-residential opportunities as the private sector identifies the latent demand.

As oil prices rise, the Government will face less difficulties in securing funding for their ambitious pipeline, although all major projects continue to be under intense budget scrutiny as the Emirates attempt to bring their budget under control. While Dubai and Abu Dhabi have already seen extensive investment to this end, there has been an uptick in construction activity in the other emirates. Across the whole country, a large urban population and significant GDP per capita is ensuring demand for infrastructure remains robust: in particular social infrastructure will see significant investment as the Government looks to cater to the primary needs of its citizens.

The transport sector is also expected to outperform in the coming years as the Government continues to invest in its position as a logistics hub, as well as in facilitating connectivity in the economy as it looks to diversify.

However, the market is still dealing with the hangover of the real estate collapse in 2015, including constrained access to credit. Project finance operations, in Dubai and elsewhere, are onerous, and international credit markets remain wary of the UAE, and in particular Dubai. This is slowing down project awards and overall market activity despite the strong potential in the pipeline. On top of this the real estate collapse has heightened attitudes to risk in the country, which is impacting the pipeline of new developments. All major schemes are going through multiple rounds of review and rethinking to maximise margins in the light of slowing real estate prices (commercial, retail and residential).

KINGDOM OF SAUDI ARABIA

Saudi Arabia has seen some turbulence in recent years with low oil prices forcing the Kingdom to wean itself off reliance on oil revenues to fund budget deficits. Now, with rising oil prices, the construction market is returning to growth and is due to pick up significantly from 2019. This growing economy will have a natural knock on effect of increased demand for construction across the Kingdom, especially after a few years of delayed projects and plans, driving construction value growth over 4% in 2018.

Burgeoning structural demand from an increasingly demanding population is driving investment into energy and utilities to ensure services are available for all. The demand for water will be a big driver of investment growth in the utilities space over the coming years as the Government looks to ensure water security for its citizens.

Alongside this, the country's ambitious economic diversification programme is facilitating growth in its transport and non-residential building segments. Saudi Arabia continues to look for private funding for much of their planned pipeline, and are receiving positive responses from the regional supply chain. As project activity ramps up, eager multinationals are flocking into the market, often choosing to partner with local companies in the first instance to gain swifter access to Public Private Partnership (PPP) opportunities.

Serious challenges remain in the Saudi Arabian market, not least the heavy reliance on migrant labour due to a lack of domestic workers. Government efforts to increase national employment in construction have so far not proven successful, and the consequent crackdown on visas and migrant workers has created steep labour shortage which is driving up labour costs. On top of this the domestic production of building materials is no longer keeping pace with demand, which will drive up prices. With high demand across the region, material prices are likely to rise elsewhere as well, meaning imports are likely to also see rising costs.

Outside of growing costs the market's main worry is certainty of the pipeline. The majority of projects in Saudi Arabia remain funded by the Government and are therefore tied to the revenue context. Oil prices are forecast to stay relatively high in the short term, allowing Saudi Arabia the time it needs to set itself well on the path to a diversified economy. Should the country face volatile, low oil prices we will see projects dropping out of the pipeline, leaving suppliers empty handed.

QATAR

In the last edition we highlighted the growing construction costs and potential for delays and cancellations that Qatar was facing due to the embargo from five Gulf Cooperation Council (GCC) states. However, the market looks to have coped incredibly well with the diplomatic crisis. Domestic labour markets were developed in response, and both alternative trade routes and increased domestic production developed for building materials. Domestic stockpiling of building materials in the years prior to the crisis meant that few projects ended up having to be delayed or cancelled. Interestingly, the embargo may have strengthened the Qatari construction market long term, by forcing them to be more self-sufficient.

The combination of the significant amount of work for the Fifa World Cup 2022, improved fundamentals being driven by adaptation to the embargo, and strong investor confidence in the market has resulted in forecast construction output growth of 15.4% in 2018. Investor confidence in the country remains high, and public spending is currently expansive: a recipe for both private and public money funding growth across all sectors of the construction market, creating a wide range of opportunities for the industry. Given Qatar's budget's relative insulation from oil price fluctuations due to the Government's substantial financial reserves, the positive outlook for Qatar is unlikely to shift without a major shock to oil and gas prices.

In preparation for the World Cup in 2022, transport infrastructure has been allocated $11.54bn in the 2018 budget - a significant increase on the previous year - while 2022 World Cup projects also received a healthy chunk of capital spending (QAR11.2bn). It has included numerous new sporting stadiums, retail and office developments as well as housing projects, both planned and underway, all contributing to robust non-residential and residential construction growth.

With ambitions to improve health and education services the Qatari Government is also funnelling money into the social infrastructure sector, creating a myriad of smaller scale construction opportunities alongside the large scale projects for the 2022 World Cup. This policy, and the pipeline of large scale works, will make non-residential construction the strongest growing sector in 2018, followed by railways.

OMAN

With growing oil prices loosening the purse strings and putting money into the average Omani's pocket we will see economic growth pick up to 3.2% in 2018 and 3.6% in 2019, from only 0.6% in 2017. This rapid economic growth will feed through to construction demand, particularly for housing and the commercial and retail sectors.

Economic growth, strong structural demand for services and the policy of diversifying the economy are all contributing to Omani outperformance in the regional construction market, growing at 9.9% annually over the next five years. However, despite efforts towards diversification, the economy remains very tied to the price of oil. Should forecasts prove mistaken, and a return to low oil prices be on the cards, Oman's strong economic position will not last long.

Oman is also pursuing a strategy of economic diversification, focused on investment in infrastructure and tourism development. The wealth of historical sites and a rich natural/scenic environment is providing a good basis for tourism, with applications for 81 new hotels in May this year. The geographic location of Oman also lends itself to developing into a regional logistics hub, an aim actively pursued by the diversification strategy, creating opportunities for the construction sector. While many countries are starting from scratch in their use of Public Private Partnership frameworks, Oman has significant experience in this funding model for infrastructure projects and will continue to attract strong inflows of private investment by leveraging this expertise.

At the same time their growing population is increasingly demanding services from their government, creating strong structural demand for infrastructure in the transport and social sectors, as well as increased demand for water and energy. In fact, water and desalination infrastructure in particular will be a source of opportunity in the construction sector as the Government rushes to build enough to meet the future water demands of their arid land. Combined, the structural demand for infrastructure and the diversification policy will result in broad based growth for the sultanate across construction sectors.

EGYPT

After some turbulent years, punctuated by security threats and a large currency devaluation, macroeconomic stability has returned to Egypt, and the country will see the strongest economic growth in the MENA region over the next five years. GDP is forecast to grow by 5% in 2018, and by 5.4% in 2019. The combination of a positive economic environment and growing public and private investment into construction will make Egypt's construction market an outperformer in the region.

With a lot of catch up to be done on serving the basic infrastructure needs of the young and swiftly growing urban population, the power and rail sectors will see the strongest growth. This growing population is also driving demand for housing, resulting in the Government undertaking several major urban planning programmes to address this need. Government investment in basic needs will run alongside growing demand from the middle class as economic fortunes improve, strengthening demand for residential and non-residential construction and incentivising private investment.

Opportunities in the water sector are also likely to see some growth over the coming years, as diplomatic solutions have failed to block an upstream dam of the Nile in Ethiopia, threatening water security in the country. As such, the Government will be forced to invest to ensure continuing supply of water into the future, whether the dam is built or not.

However, given the elevated risk profile compared to regional peers, these major opportunities do not come without their dangers. Key challenges include a poor operating environment, inadequate regulatory frameworks and persistent political and security risks, as well as a penchant for hard-to-deliver megaprojects. But with a relatively weak currency, strong growth outlook and suitable Public Private Partnership framework, as well as the backing of multilateral agents, we expect foreign investment to continue to play a significant role in driving construction across sectors in the Egyptian market.

Mace
Aspect Tower: Business Bay – Executive Towers
Zone A – Level 21: Office No. 2104
Sheikh Zayed Road
Dubai
United Arab Emirates
+971 4 447 0207

Mace
155 Moorgate
London EC2M 6XB
+44 (0)20 3522 3000

Contacts

Paul Donaghy	+971 4 447 0207	paul.donaghy@macegroup.com
Steven Mason	+44 (0)20 3522 3595	steven.mason@macegroup.com