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Construction industry collapses are caused by the wrong builder, not the wrong contract

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COVID and its associated lockdowns and supply chain blockages have been tough on Australia's property construction sector. An inability to source labour and materials has resulted in steep rises in costs and substantial project delays, which have wiped out margins and in recent months driven some of the industry's highest-profile names to the wall.

Around the country, there is heightened anxiety regarding unfinished residential and commercial projects, developers considering alternative builders, subcontractors and tradies waiting to be paid, and would-be homeowners and investors wondering what this means for the apartment they've bought off the plan.

The industry is also looking for answers. Why has this happened? And what can be done to prevent it happening in the future – beyond preventing global pandemics?

It's no surprise that attention has turned to Australia's preference for Design and Construct contracts. There are suggestions we should look to the US, where D&C contracts are far less common and developers, not builders, take on more of the risk and responsibility of a new development.

Superficially, that may appear attractive. Surely developers should be more responsible? But it would be a serious mistake. D&C contacts have served Australia well through multiple property cycles and remain the best option for allocating risk and incentivising project completion, quality and innovation in design.

In Australia, there are several types of commercial contracts for large residential projects – our focus for this article, although it's the same situation with commercial projects. There's a construction management agreement, with no fixed price and much of the cost risk and design risk borne by the developer. There's a gross maximum price contract, which is a better option for developers although they still carry design risk. And there are D&Cs with a gross maximum price (GMP) or a fixed price.

The principal benefit of D&C GMP contracts, which are by far the most popular for larger projects, including large-scale infrastructure projects, is that the many risks are assigned to the maximum extent possible to the one party best able to manage them – the major contractor or builder. A D&C contract makes it clear that the builder is responsible for the delivery and construction of the project in accordance with the detailed design plans.

The reason for this approach is to reduce the risk of disputes and litigation between the many parties to a major project – the developer, the financiers, off-the-plan purchasers, the head contractor and their subcontractors, the multitude of design, engineering and planning consultants and the surveyors.

Effectively, all roads lead back to the builder. If there are any problems – the project is late, there are cost blowouts, pre-sales fall over because there are design faults, there are warranty claim safter completion – it is the builder's responsibility to deal with it. There is a direct and central point of liability in the event something goes wrong.

This makes D&C contracts attractive and fundamental from a financier's point of view. But it also highlights why the financial strength, experience and track record of the builder is paramount in any project.

The key argument against D&C contracts, which has gained currency with the spate of recent collapses, is that they remove the responsibility from the developer because they have passed all the risks to the builder. This betrays a misunderstanding of the role of developers and the amount of skin they have in the game.

In Australia, the funding of costs for a major residential project is typically 70 per cent debt –from a bank or, increasingly, from alternative lender – and 30 per cent equity from the developer. The developer will also be eyeing a 20 per cent profit margin. On a $200m development that's up to $100m of at-risk equity and profit, so it's nonsense to say developers are not motivated to deliver a successful project on time and on budget.

In the US, where D&C contracts are rare and prohibitively expensive, a developer typically has even more skin in the game but there are significant downsides, particularly when something goes wrong.

Unlike Australia, in the US more of the risk emphasis is placed on the developer and the strength of their guarantee to the financier, as opposed to the contractor's guarantee. This results in a substantial shifting of risk away from the contractor to the developer. It results in the dilution of the risk matrix.

In the US, the equity risk is so profoundly different to that in Australia that equity raisings have complicated tiering structures of differing risks depending on which tier of equity you subscribe to. It's a complicated and inferior system to that in Australia where all roads lead to one party being the contractor – the party that actually did the work and had responsibility for all other subcontractors and consultants.

In the litigation capital of the world, you can imagine the outcome in the event of a problem with a project. Without the single point of liability under the D&C system, everyone blames everyone else and lawsuits fly.

Doing away with D&C contracts in favour of such a system is simply not the answer to the current problems facing the construction sector. It would introduce greater risks for developers, financiers and, ultimately, for homeowners and investors. In addition, by requiring developers to put up more equity to cover increased risks, it would lead to higher development costs and higher apartment prices that would only exacerbate the current housing affordability issues.

The current problems in construction are not about the wrong contract. In most cases where there is failure, it's about developers choosing the wrong builder. You may have the best-in-class

suite of contracts and risk assessments, but you need the appropriate builder to execute according to the terms of the contract.
As a financier, before we put up any funding, we naturally assess all the risks and returns of a project.

One of the most important considerations is the scale and quality of the builder, specifically whether they have the experience and balance sheet to carry out a particular project and cover the financial burden of any problems that emerge.

The temptation in a climate of rising costs – including the cost of capital – is for developers to look for cut-price construction options, including taking on cheaper but riskier GMP contracts without a D&C component. The more inexperienced the developer, the more likely they are to run into problems managing the D&C components with the builder, leading to cost blowouts and delays.

Even with a D&C GMP contract, the lowest bid is typically from the lowest-capitalised, least experienced builder. In a costs crunch, as we've seen through Covid, they will be the first to fail.
We have one of the best contractual arrangements anywhere in the world, designed to ensure a clear pathway of responsibility to contractor. The D&C contract attributes responsibility for the design of the building, the structural integrity, performance, and warranties with the builder. There is no gap for error – unless you choose the wrong builder due to an incorrect assessment of their financial capacity.