The Future of Fixed-Price EPC Projects

Many of the major engineering, procurement and construction (EPC) companies are highly-leveraged financially and are facing significant cash flow pressures. The high leverage of some of these companies was caused by the large, over-priced and poorly-timed acquisitions they made since 2014. Some of these companies have been under cash flow stress for years and have had several rounds of layoffs.

> *Several of these companies now have substantial <u>negative tangible shareholder's equity.</u>*
> *In other words, the value of their total liabilities exceeds the value of their tangible assets.*

The financial pressures in the EPC industry persist due to several factors:

- Heavy debt burdens remain from the recently-financed acquisitions.
- Cost overruns incurred on fixed-price EPC contracts, and the resulting litigation.
- Heavy multinational competition for cost-plus or "reimbursable" service contracts.
- Significant declines in capital spending since 2014.

Some major EPC companies have defaulted on and restructured their bank credit agreements. It has become more difficult for these companies to obtain performance bonding and letters of credit. Boards and management seek to reduce risk and leverage, yet to increase margins.

> *Many leading EPC companies have <u>explicitly pulled out of the fixed-price EPC business</u> and are struggling to survive by competing for lower-margin, reimbursable engineering, procurement and/or construction service contracts.*

Adding to the difficult circumstances in the EPC business, the world's economy has begun a deep, Covid-19-driven recession, which may last well into 2021. It is doubtful that government stimulus money that may be made available for *infrastructure* will quickly have an impact.

Substantial recent growth in *oil and gas* production and LNG capacity has led to production gluts and to extreme price volatility. Long term contracts are being cancelled, and leading oil and gas companies are reconsidering or cutting their capital investment plans. Capital spending in the *mining* sector has grown lately but remains well-below 2014 levels. Spending in the *electric power* industry has been relatively strong, but has begun to decline. There have been areas of growth, including in *renewable energy*.

The world's economy will eventually recover. Financial markets are still sitting on trillions in liquid investment capital and interest rates remain historically low. Once Covid-19 is under control, economies and capital projects will begin to rebound. Project owners will still have strict capital investment budgets and schedules, however, on which the economics and financial viability of their projects depend.

With few strong competitors remaining in the fixed price EPC business, experienced and well-capitalized EPC contractors are now in a better position to bid for and win higher-margin fixed price projects.

Now is the time for <u>financially-sound EPC companies</u> to rebuild their fixed-price EPC skills, disciplines and mentality, and to selectively re-enter this higher-margin business.

Now is also the time for <u>viable project owners</u> to build their internal project management teams, in the event they are unable to find satisfactory fixed-price EPC contractors.

The keys to success in the fixed-price EPC project business include the following:

- *Pursue fixed-price projects only in industries where the EPC firm has successful experience.*
- *Pursue projects backed by serious and financially-viable owners and off-takers.*
- *Carefully select and retain the key professionals on each project management team.*
- *Understand the scope thoroughly, evaluate the risks methodically, and bid accordingly.*
- *Include adequate risk-based profit margin and additional contingency reserves.*
- *Use straightforward EPC agreements, with well-defined scope, schedules and payment terms.*
- *Structure flow-through terms and conditions with subcontractors.*
- *Include clear and timely change order procedures and interface protocols.*
- *Include limits on potential damages.*
- *Maintain frequent scheduled, structured communication within project teams and with client and subcontractor counterparts. Document meetings, communications and responsibilities.*
- *Identify and respond quickly to risks and issues that can affect cost, schedule and performance.*

The author, Chip Gehle, has worked with several prominent EPC companies in the evaluation, selection and management of fixed-price EPC projects in the oil and gas, electric power and infrastructure sectors. Chip also has many years' experience in domestic and foreign project financing and in problem resolution.   He assists with new and existing project situations, in cooperation with experienced EPC professionals and with reliable project financing sources.

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