Challenges with Design Build Contracts
Objective
- Review lessons learned through Initial Development Period (IDP) process
- Explore strategies for out-year projects

Discussion Topics
- Provide basic definitions / contract types
- Review team structures
- Discuss IDP contracting priorities and strategies
- Explore out-year contracting priorities and strategies
- Understand transaction documents
- Develop implementation strategies
• Project Owner is partnership
• Developer & D/B Contractor contracted by Owner
  – Separate entities
  – Frequently affiliated
  – Roles defined by contracts
• Developer
  – Manages project for Owner
  – Assumes virtually no risk
• D/B Contractor
  – Assumes risk based on contract terms
  – Engages/manages design team
  – Engages/manages subcontractors
IDP Project Characteristics

• Mega-projects
  – $300M to $500M common
  – 5 to 7 years common
  – Negotiated so that each project has some type of guarantee to include scope, schedule, and budget

• Risk transfer a critical factor
  – Guarantees require significant financial capacity
  – Contractors provide most of the substantive guarantees
    • Large balance sheets
    • P&P bonds to back obligations
    • Engagement of subcontractors a phased activity in most cases
Risk transfer has a cost
- More uncertainty increases cost
- Multiple contracting activities
- Major time risk
- Complex process for multiple bids

Cost reflected in several ways
- Significant contingencies in D/B GMP
- Large staff to manage contracting
- Larger entities have higher overhead
- Multiple levels of markups for overhead and fee
- Risk assumption commands premium fee levels
- Change Orders for escalation, assumptions, allowances increase GMP

Strategy driven by IDP project needs
- Total development budget $368M
  - Typical project budget
- How much goes to actually build?
  - About 53% to direct field costs
  - Varies with deal structure
- Where does the rest go?
  - Financing/closing costs
  - Soft costs
  - Fees
  - Overhead
  - General Conditions
  - Insurance & Bonds

<table>
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<tr>
<th>Hard Costs</th>
<th>Cost ($)</th>
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<tr>
<td>Vertical Costs</td>
<td>116,517,835</td>
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<td>Site Work Costs</td>
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<td>Landscaping</td>
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<td>Renovations/Conversions</td>
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<td>Demolition</td>
<td>9,220,362</td>
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<td>Utilities Infrastructure</td>
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<td>Amenities</td>
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<td>Inflation</td>
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<td><strong>Subtotal Hard Costs</strong></td>
<td><strong>246,486,312</strong></td>
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<th>Construction Soft Costs</th>
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<td>General Conditions</td>
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<td>A&amp;E Fees</td>
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<td>D/B Contingency</td>
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<td>D/B Overhead</td>
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<td>D/B Fee</td>
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<td><strong>Subtotal Const Soft Costs</strong></td>
<td><strong>56,496,160</strong></td>
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| Subtotal GMP                            | 302,982,473 |
| Development Soft Costs                  |             |
| Developer Fee                           | 12,858,880  |
| Developer Staff                         | 2,000,000   |
| Development Contingency                 | 9,089,474   |
| Construction Consultant                 | 4,905,000   |
| Project Insurance & Bonds               | 6,659,542   |
| Environmental Testing                   | 5,000,000   |
| Other                                   | 3,006,065   |
| **Subtotal Dev Soft Costs**             | **43,518,961** |

| Financing/Closing Costs                 |             |
| Transition and Legal Costs             | 6,695,118   |
| Financing Costs                         | 5,958,567   |
| Title Insurance                         | 796,128     |
| Reserves                                | 4,310,453   |
| Insurance                               | 1,443,336   |
| **Subtotal Financing/Closing**          | **19,203,602** |

| Total Development Budget               | 368,748,648 |
Result – The Incredible Shrinking Dollar

- **Subcontractor** – 80% to build
- **D/B Contractor (GMP)** – 65%
- **Development Budget** – 53%
- **Private Sector Project** – 67%
  - Financing accounts for 5%
  - Remaining 62% is 17% improvement beyond 53%

- **Development Budget Dollar**
  - Spent Private Sector Project

- **Development Budget Level**
- **D/B Contractor Level (GMP)**
Most projects will be much less complex
- Scope limited to a single phase over 1-2 years
- Budgets more in the $10M to $50M range
- Funded from reinvestment account vs. debt

Can implement with streamlined structure
- Go direct to subcontractors in single increment of bidding
- Use local resources like major local homebuilders
- Single procurement with no upfront risk transfer
- Requires significantly less management effort

No water-skiing behind aircraft carriers
- Match contracting structure to the task
- Retain the risk as Project Owner until it can be directly passed to subs
- Drive more of the development dollars to the field
How Do You Improve Efficiency

- Optimize use of the Project Team resources
  - Review documents for potential constraints

- Developer brings contracting strategy and resources
  - Development Agreements typically for full 50 year duration
  - Compensation established as function of work managed
  - Has obligation to optimize Owner’s interests (not contractor’s’s)
  - Needs to provide skill set to examine alternative strategies

- D/B Contractor typically hired for IDP services only
  - Some operating agreements establish preferential role for out-years
    - Most do not mandate use of affiliated D/B
  - Terms of engagement are frequently not established for out-years
  - Compensation should be commensurate with risk assumed
  - Engagement should be evaluated on competitive basis
Actual Case Study

- Development budget roughly $300M
  - 708 new homes, 700+ renovations of various types
  - 9 year IDP in 7 planned construction phases
- By commitment of 4th phase escalation threatened scope
  - Contract escalation provisions exceeded budget capacity to absorb
- Owner creatively explored alternatives
  - Adopted strategy that had worked effectively at other project
  - Broke the remaining phases into smaller increments
  - Enabled smaller local contractors and subcontractors to execute
  - Tapped the expertise and connections of local homebuilders
- Results – delivering to original budget
  - Nominally completing on original schedule
Actual Case Study (Cont.)

- Exceptional product
- JNCO homes
  - Single family vs original duplex
  - Premium cabinets
  - Stainless appliances
  - Granite tops
  - Vinyl plank floors
  - Vaulted ceilings
- Creativity works
Types of Contracts

• Contract Structures
  – Developer (Owner advocate, specialized expertise, little/no risk)
  – General Contractor - Design/Bid/Build (Owner hires design team)
  – General Contractor - Design/Build (design team works for Contractor)
  – Construction Manager (CM – hires/manages subs, could assume risk)

• Contract Financial Structures
  – Lump Sum (Fixed Price – use when scope is clearly defined/simple)
  – Guaranteed Maximum Price (Cost plus, GMP, Shared Savings)

• Contract Protection Alternatives
  – Payment & Performance Bonds (ensure contract performance)
    • Subguard policies (protect Contractor from subcontractor defaults)
  – Insurance programs (protect insurable events)
    • OCIP (Owner controlled, wrap-up policy, complicated to administer)
    • CCIP (Contractor controlled wrap-up, efficient from contractual perspective)
    • Conventional (each entity provides their own coverage, simple)
Out-Years – Match Strategy with Complexity

- Simple out-year projects funded from Reinvestment
  - Roof replacements, extended change of occupancy maintenance, etc.
  - Limited trades and complexity
  - Developer could facilitate procurement and contracting for Owner
  - Monitor progress of the work without a separate general contractor

- More complex single phase projects
  - Renovations of a neighborhood
  - Demo and rebuild a small neighborhood
  - Developer could develop and implement strategy
    - Hire design team on behalf of Owner
    - Competitively bid to local home-builders
    - Monitor the progress of the work
  - Potentially use affiliated Contractor in CM role to manage work
    - Structure fees commensurate with limited risk transfer
Out-Years – Match Strategy with Complexity

- Major mid-term renovations & rebuilds
  - Consider original IDP structure if multiple phases, complexity and/or debt funding
  - Limit risk transfer if funded from reserves
    - Owner has risk going into a midterm project
    - Do not pay risk transfer premiums unless there is value in doing so
  - Utilize Developer to examine strategies
  - Engage affiliated contractor if it adds value
    - Enhanced management capacity
    - Expedited design/construction process
    - Consider CM role without risk transfer to achieve objectives

- Alternatives may require revised approval process
  - Major decision approvals for project on conceptual budget & strategy
  - Update approvals based on actual bid costs
• Recognize fundamental differences in projects
• Discuss opportunities with project owner
• Need to work within the confines of the current legal structure/agreements
  – Complexity requires involvement of HQDA
  – May be opportunity for negotiation
  – Need to determine risk/reward relationship
• Focus on driving as much budget as possible to scope
  – Shift another 5% to field
  – Yields 10% increase in scope