Case 22

DHAHRAN ROADS (A)

Hassan Malik, the financial manager of SADE, a Bahrain-based civil engineering company, reread the recently received fax. He was delighted that the nearly endless conversations with the Transportation Ministry of the municipality of Dhahran in eastern Saudi Arabia were finally coming to a close.

SADE had been selected as the prime contractor for an 168 million Saudi riyal (SR) project that involved the reconstruction and upgrading of the highway network linking the several terminals of the Dhahran airport and connecting the entire complex with the city. The Dhahran Roads project was indicative of the types of projects on which SADE had established its international reputation for being a leading construction contractor. The total cost of the project was estimated to be SR 146 million, so the SR 168 million value provided only a 15 percent return, which was, unfortunately, below the 18 percent hurdle rate required by SADE for projects of this nature. On the other hand, the slightly less-than-desired return seemed a small cost to pay to maintain a steady flow of new projects during these slow economic times.

The fax requested that Malik respond to the project proposal within a week. The working of the contract would then be finalized in the subsequent weeks, and the contract signed by mid-January 1993.

THE PROJECT

The terms of the proposed contract contained several provisions:

- At the signing of the contract, the ministry would advance to SADE 15 percent of the contract's total value.
- If work progressed on schedule, SADE could bill the Ministry as milestones were reached in accordance with the following schedule:

1993	SR 11,000,000
1994	SR 36,000,000
1995	SR 45,000,000
1996	SR 43,000,000
1997	SR 33,000,000

- The Ministry would pay 80 percent of each bill received. Payment would, of course, be subject to a satisfactory inspection of the site by the Ministry. The 20 percent deduction would be withheld for (1) the recovery of the advance payment (15 percent) and (2) the accumulation of a retention fund (5 percent).

- Half of the retention would be reimbursed at the time of completion (end of 1997). The second half would be repaid at the end of 1998, provided the roads did not show any flaws in their first year of use.

During the past several months, the SADE engineering department had inspected the site, confirmed the surveys, and reviewed the drawings that had been provided by the Ministry. In the opinion of the vice-president of engineering, the project presented "no unusual challenges." It was similar to several SADE projects in other countries that had moved ahead without difficulty and were now nearly complete.

For SADE to proceed, equipment would have to be ordered immediately to ensure availability in the fourth quarter of 1993, when earth moving would commence. The cost of the equipment would be SR 38 million. Seventy-five percent of the cost would have to be paid upon placement of the order; the balance was due on delivery. At the end of the project, the equipment would have no salvage value. The engineering department estimated the cost of completing the project, excluding the equipment, would be SR 108 million. SR 7 million would be expended in 1993 for preliminary site work. The project would then proceed with estimated costs of SR 25 million, SR 29 million, SR 27 million, and SR 20 million for the subsequent years.

Preliminary discussions with several banks indicated that SADE would be able to raise SR 4 million in loans to help finance the project. The loans would carry a 12 percent annual interest (2 percent above prime, 5 percent above government securities) and would have to be repaid in full at the end of 1997.

The project would be managed by one of SADE's experienced project managers, Harold Smithers. Smithers had just completed a major waterworks project in East Africa and was noted for strong engineering skills and tight fiscal control.

Although the contract would be denominated in Saudi riyals, the foreign exchange exposure would be minimal since the Bahraini dinar was pegged to the Saudi riyal. In addition, Saudi Arabian and Bahraini tax laws would not require SADE to pay taxes on the profits of this contract.