

CONSTRUCTION BUSINESS DEVELOPMENT TENDENCY IN POST- CRISIS GEORGIA

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Abstract

After August events of 2008 (the Russian-Georgian war and the world financial crisis) the construction business reached deadlock. Say nothing of small and medium companies, most of the leading development-construction companies faced the danger of bankruptcy. Despite the improvement of statistical indicators in recent years, the construction business is still in the active phase of its crisis. Financial resources (loans issued by the banks) providing active capacity of construction business are entirely blocked. This work immediately highlights the construction business problems and its development tendencies in post-crisis period in Georgia. While developing this work, we thoroughly processed officially declared statistical information of construction field. We read and analyzed materials related to these issues. Moreover, we conducted independent study, compiled questionnaire and arranged interviews with the founders of the development-construction companies. We talked to government authorities and commercial banks' representatives as well. Obtained results reveal, that, expectations about banks' activity increasing with respect to the construction business financing remained an illusion. Commercial banks' interest towards the development business is causing to stop financing construction companies.

The type of the article: Research report.

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JEL Classification: M10.

1. Introduction

After Rose Revolution, particularly in 2004-2007, **construction business**¹ developed so rapidly in Georgia that it became some kind of “business card” of political and economic development of our country. Increase of capital investments in this field, scope of construction works, value added in construction, number of employees and other economic indicators reached their peak in 2007 and the country was covered by “construction boom”. The Russian-Georgian war and the world financial crisis set limits to the casual attitude towards the construction business, demonstrating that the certain results emerged on the surface of the events, rather than reflecting reality, which revealed the real problems pertaining to the construction business itself. It concerned financial resources attraction and disposition wrong mechanism in the field applied by almost all the construction-development companies that caused material loss and moral damage to the numerous citizens.

Introduce the problem

After August events of 2008, the construction business appeared in front of serious problems. Say nothing of small and medium enterprises, most of leading development companies faced on danger of bankruptcy. Financial recourses (loans issued by banks, savings of local citizens, as well as Georgians living and working abroad and the foreigners themselves, who had vested interests in Georgian real estate) providing active capacity of construction business, were entirely blocked.

¹ Our research is mainly focused on residential-real estate construction business, as the construction crisis directly affected the development- construction companies, that were active in construction residential real estate properties.

Despite of the Government project “New life of old Tbilisi”, which partially promoted overcoming the problems in the construction sector and helped improve overall statistical indicators as well as the relationships between developers and commercial banks, the expectation about increasing bank activities with respect to financing construction businesses remained as an illusion. Banks explain, that they find high risky to invest financial recourses in construction companies, because of their poor management and unqualified running of business. On the contrary, developers had different view: they directly accused and criticized commercial banks of their individual business interests in the real estate development sector, which is not specific to banking in general. In accordance with a discussion above, the following issues can be pointed out:

- 1) Incompatibility between officially declared statistical information and the real situation in the construction-development business;
- 2) The government’s role and corporate social responsibility issue;
- 3) Confrontation of two parties: Construction-development business and banking sector.

Develop the background

While developing this work, comprehensive analysis of statistical data of the construction industry was conducted. For the purpose of acquiring statistical information statistical Year Books and information from the web-site of National Statistics Office of Georgia were employed. Additionally, the following research papers were carefully read and analyzed: “Dynamics of Construction Development and Organization of Management in Georgia” by Kikutadze (2009), “Impact of Economic and Financial Crisis in The Construction Industry” by Ploscaru (2010), “Enhancing Completing Factors of Construction Business in Georgia”, by Iakobidze (2010), “The economic situation and construction-sector development in the UNECE region” – Annual Market Review, 2011-1012, “Analysis of Tbilisi’s Real Estate Boom” by Rukhadze (2008). It is noteworthy to point out that throughout the past several years a lot of TV programmes were dedicated to the construction business problems. Expert economists, the owners of development-construction companies, the commercial banks and the government representatives are permanently interviewed by different periodical newspapers and Georgian news agencies, which underline the fact that the problems in this field are still active.

State the purpose and rationale background

After thorough research the purpose of this work turned into discovering and identifying the exact underlying causes for the major issues in the field of real estate construction as well as generating logical assessment and conclusion regarding its’ developing tendencies. It is essential to highlight problematic issues in this sector, as a construction field usually fuels and supports the developments in the rest of the sectors of national economy.

2. Method

There were used method of statistical observation, sorting and analysis while working on this paper. Officially published statistical data was carefully processed, analyzed and presented. Additional research methods include: studying and exploring various newspaper articles, research papers as well as performing an independent study comprising direct surveying and interviewing key individuals that have significant roles in the related fields. The following company representatives were approached and presented with the survey questionnaire: Arci Ltd., 7-Sky Ltd., Kid Architects Ltd., JSC. Dexus Development. The interviews were conducted with the representatives of the following local banking institutions: JSC TBC Bank, JSC Bank of Georgia, JSC KSB Bank and JSC Bank Republic. Additionally, selective opinion polls were performed in the streets of Tbilisi.

3. Results

At the first sight, officially declared statistical data looks confident and optimistic.

Macroeconomic indicators show as if the post-crisis period in the construction field is more or less overcome and the sector is fully rehabilitated (see Table 1).

Table 1. Statistical indicators for construction industry (2007-2012)

Indicators	2007	2008	2009	2010	2011	2012
Production value in construction (mln. GEL)	1718.2	1434.7	1752.6	1728.5	3371.5	3798.4
Value added in construction (mln.GEL)	1141.1	1058.3	1004.3	1100.0	1407.9	1638.5
Share of construction value in total GDP	6.7%	5.5%	5.6%	5.3%	5.8%	6.3%
Number of persons employed in construction	52572	38109	43452	40303	65220	67135
Average monthly remuneration of persons employed in construction (GEL)	495.1	600.9	929.0	674.6	741.3	1022.5
Turnover in construction (mln. GEL)	1604.6	1412.0	1736.3	1694.5	3348.0	3791.3

Source: www.geostat.ge

The 2007 macroeconomic indicators were used as the basis for comparison, since the year 2007 represents the peak year for positive macroeconomic figures after the Rose revolution of 2004 prior to the crisis of 2008. The Table 1 shows that in 2009-2010 the construction sector was in the process of rehabilitation and after 2011 economic growth tendencies can be observed. Namely, in 2011 as compared with 2007, the following changes are evident: the production value in construction increased by 96.2%. Value added in construction increased by 23.4%, number of persons employed went up by 24%, average monthly remuneration of employed persons increased by 50% and turnover of construction companies – by 108.7%. As far as the decreasing share of construction value in total GDP is supposedly due to other sectors of economy being more active than the construction field. Stable growth of macroeconomic indicators is given in year 2012 as well, specifically, in compared with 2011, the following changes are obvious: the production value in construction increased by 12.7%. Value added in construction increased by 16.4%, number of persons employed went up by 2.9%, average monthly remuneration of employed persons increased by 37.9% and turnover of construction companies increased by 13.2%. In comparison with the previous years the share of construction value in total GDP is increased, which shows the growing tendency of construction business along with other sectors of the economy.

It is worth mentioning that the initiative of Tbilisi City Hall known as the “New life of old Tbilisi” has greatly supported the rehabilitation and recovering of construction sector after the crisis. The purpose of the project was the following:

- 1) To improve the living conditions for those citizens, who lived in the old houses of the old district in the city;
- 2) To recover the damaged relationships between the construction companies and the banks;
- 3) To help construction companies resume construction works and fulfill their social obligations.

The project scheme was so that the construction companies were to negotiate a deal with the citizens living in the old districts of Tbilisi. The part of the deal was to have those people, living in the old districts, empty their old houses and move into the newly built residential apartment complexes, construction of which was to be financed by local banks under the Government guarantee program. The parties involved in the scheme would benefit as follows:

1. The government would get free lands in the old districts to be used for future investment projects;
2. The construction - development companies would receive financing from the banks, which would enable them to complete unfinished construction projects and fulfill their obligations in front of those people who had made investments in the given construction projects;
3. Commercial bank would receive Government guaranteed additional income streams. The project started in 2009 and is presented in phased manner (see Table 2).

Table 2. Tbilisi City Hall project “New life of old Tbilisi”

Years	Project Phase	Number of financed construction-development companies	Number of participating banks	Volume of financing
2009	I	11 development companies	4 commercial banks ²	53 000 000 GE L
2010	II	9 development companies	4 commercial banks ³	46 700 000 GEL
2011	III	Number of the development companies, which accepted pre-purchase agreement from Tbilisi City Hall		The value of pre-purchase agreements
		14 development companies		64 000 000 GEL

Source: www.tbilisi.gov.ge; www.developers.ge

The first two phases of the project were quite productive for all parties and construction works are still in progress. In 2011 the phase III of the project was announced, although it had modified content and intentions. Precisely, any construction company that wanted to start a new construction project or continue and finish an ongoing, unfinished project was allowed to make a pre-purchase agreement, according to which Tbilisi City Hall would buy back dwellings with a price of \$400 for 1 sq. m in case the developer was not able to sell them within a reasonable period of time. It should be mentioned that such mechanism of government guarantee was more appropriate compared to that of in the previous phases, whereby the government was directly financing a construction business, by paying back banks loans (principal amount plus accrued interests). However, even though in the final phase construction companies had guaranteed buyers for finished projects, they had no funding for construction. It was expected that banks would continue or increase financing such projects, but regrettably events developed absolutely contrary and banks showed augmented reluctance in issuing loans to constructions firms. One logical explanation of this fact is that today commercial banks are thriving by tapping into the untapped waters of residential real estate construction industry and are becoming more and more interested in conducting construction and related financing activities on their own (see Table 3).

Table 3. Commercial banks’ interest in development sector

Commercial Bank	Related Development Company	Form of relationship
Bank of Georgia	JSC “SB Real Estate”	Wholly owned subsidiary of JSC Bank of Georgia
Bank Republic	Redix	Partnership (Bank Republic owners are members of board of directs of Redix)
TBC Bank	LISI Development	Partnership (TBC bank owners are members of board of directs of LISI Development)

Source: www.sbge.ge; www.redix.ge www.lisi.ge

Conflict of interests is clear. While it is true that there are 17 more smaller commercial banks in Georgian that have not shown interests in entering non-banking and unrelated industry of residential construction, this fact does not alienate or weaken the problem areas. Moreover, the rest of the banking institutions have never even shown interests in financing real estate in the past but those institutions, which were involved in real estate one way or another evidently tasted the potential rewards of the construction industry and continue to cope successfully with developing the unrelated business areas.

4. Discussion

The research demonstrates that after the crisis of 2008 development tendencies of construction industry in Georgia are not very appealing. Despite the effectiveness of the City Hall’s initiative, known as the “New Life of of Old Tbilisi” the leading construction companies are still

² Bank of Georgia; Bank Republic; TBC Bank; Cartu Bank.

³ TBC Bank; Bank of Georgia; KSB Bank; Basis Bank.

facing the funding issues and continue to struggle meeting with old financial obligations. At the same token, the industry macroeconomic data shows different, positive picture and points to the industry's full rehabilitation in addition to macro-economic growth. The main reason for such inconsequence is that the statistical report of the National Statistics Office of Georgia doesn't segregate different segments of the construction field (e.g. construction of residential housings, non-residential and commercial buildings and strategic-purpose civil engineering, infrastructure constructions (roads, bridges, tunnels etc.) that are mostly funded by the government). Therefore, the figures presented in Table 1 represent data of construction business as a whole and not as individual, separate segments of the construction industry. This in turn produces misleading outlooks and sets limits for making sensible and accurate conclusions about the tendencies in construction business itself. Therefore, it is highly recommended that the National Statistics Office of Georgia compiles, analyses, sorts and presents data in accordance with the industry specifications.

This is another reason why an independent study was carried out that showed different results. It should be noted, however, that the most responses received from respondents of the survey of the four participating companies are identical. The results of the survey questionnaire, as well as interviews, give grounds for generalization as follows:

- Construction companies are continuing to suffer to this date as they are still struggling to fulfill old obligations. New assignments are being considered as pilot projects for discussion purposes only;
- Companies have not experienced economic growth during the periods of 2009-2012. According to company owners this was a period of recovering and rehabilitation;
- Most of the construction company owners are positively evaluating phases 1 and 2 of the City Hall's initiative, whereas the phase 3 is considered as inactive and unproductive. Instead of increasing bank financing, commercial banks entirely stopped funding construction companies;
- Compared to the real estate prices at the beginning of 2008 currently they are 10% lower, however, more stable;
- Consumers and their expectations are entirely changed on the market. If during the period of construction boom only one third of buyers were buying housing for personal uses and the remaining two thirds for investment purposes, today these two thirds practically does not exist;
- Great majority of consumers have lost confidence in construction companies as they no longer consider investments in residential real estate properties constructed by local construction companies. Today's consumers are reluctant investing in unfinished and ongoing projects, unless they are fully completed, registered and cleared by the public registry office of the city municipality, whereas, in the past at the cost of lower per sq.m prices investing in unfinished and unregistered properties was considered as common risk taking practice;
- Construction company representatives feel the government does not pay sufficient attention to supporting the development of the construction industry;
- Positive macroeconomic indicators in the construction industry are due to larger infrastructural constructions projects, not related to residential real estate developments and are being realized and funded directly by the government;
- The funding problem remains as the dominant issue in the construction industry and the leading commercial banks with one form or another are directly involved in constructing and developing real estate by themselves. It is logical to assume that banks consider existing construction companies as their direct competitors and for this reason banks no longer finance their operations. Therefore, it is paramount that the government considers imposing regulatory limitations on banks regarding non-industry-specific activities. This would guarantee the retention and survival of Georgian construction companies and at the same times their promise to meet the obligations of those citizens, who are still waiting for their homes to be completed.

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