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Market Update

Melbourne’s Stage 4 Lockdown

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How will the market adapt for the second time around?

As Melbourne enters its first week of Stage 4 lockdown, the construction industry is coming to terms with what the restrictions mean. While the restrictions imposed by the State Government are necessary to limit the spread of Covid 19, further clarification is required to better understand how the restrictions will affect various projects.

For projects over 3 levels, the required "25% of normal employees on site compared to normal operations" has many asking what 'normal' constitutes. For projects under 3 levels, which can only have a maximum of 5 workers on site, has many assuming that this is for domestic residential construction. That distinguishing point has not been clarified yet. We anticipate there will be discretion on projects that are under 3 levels but are 'large scale construction' and have a commercial contractor.

Based on the guidelines as they currently stand, state building and state civil construction is exempt from reduction targets although clarification is still required for a number of agencies as to whether their projects qualify for this exemption. We are yet to see the approach to privately led social infrastructure, local government and industrial projects.

The Impact to Contractors and Supply Chains

While contractors and their sub-contractors grapple with how to programme their works on site for the next 6 weeks, much of the supply chain (joinery, metalwork, furniture) that sits behind them is being shut down.

With only 25% of the workforce able to attend site, the reality is that productivity will reduce by more than 75% as those remaining on site will not be as productive as a full compliment.

For many sub-contractors, being able to devote personnel to one site only for the next 6 weeks is highly restrictive and will no doubt impact their ability to carry out works and will force them to choose which main contractors and projects they work for. This will likely impact smaller projects or those in their early stages.

Once sites do open again more fully, hopefully in 6 weeks' time, many projects will be reliant on a supply chain that has been closed and will require time to work through the backlog. It's important to note that this is not just about the next 6 weeks, it is a much longer period, perhaps as much as 6 months.

As cement is one of the few materials to remain open for on-site work, contractors whose critical path is structure will prioritise concrete for the next 6 weeks, probably at the expense of other trades so that they do not exceed the 25% rule.

Those contractors relying on finishes and fitout trades such as joinery are faced with a dilemma. If

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Northern Hospital Inpatient Unit Expansion Stage 2, due for completion April 2021 these materials are unavailable for installation, putting contractual issues to one side, is there any point keeping the site open?

Contractual Implications

Many construction contracts will have provision for extensions of time to be granted in the case of legislative change, which Slattery assumes Stage 4 constitutes. What is less clear is who bares the cost of the delay and that will depend on individual contracts.

We would advocate that the development and construction community show fairness and reasonableness with one another in assessing the time and cost impact. For our industry to bounce back quickly we need clients and developers to have a healthy pipeline of projects, equally we must have a healthy contracting and supply chain community to make them reality.

The View from Abroad

With so much uncertainty surrounding the current situation in Melbourne, it makes sense to look at others who have endured similar experiences to understand what may be in store.

New Zealand

New Zealand had more stringent measures with construction and supply chains shut down completely. Despite the extent of the closure, supply chains were reasonably unaffected and able to catch up more quickly when restrictions eased. Offshore procurement was affected to a greater degree, particularly from China, something that was not as prevalent in Australia.

There is reportedly a gap in workload in approximately 6 months' time. This is leading to a sharpening up of pricing with margins falling and some contractors apparently working at cost just to turnover. It is a similar situation for consultants who are pricing fees very competitively.

As a result, it is anticipated that smaller companies will go bust in the next 12-18 months. Government is attempting to provide stimulus through infrastructure projects, but these are likely to take some time to be shovel ready due to planning. However, it will see consultants swing to public sector projects as many commercial developments have been put on ice or abandoned.

United Kingdom

Slattery's collaboration partner in London, alinea, saw many construction sites close at the end of March. The supply of materials dried up as manufacturers shut factory gates. Sites that did remain open were generally working at below half the usual capacity. Since March, productivity on many sites has improved faster than expected with output achieving 75% at the end of June on most projects.

While shortages on some basic materials continue, many factories are now open and getting back to capacity with European materials now coming through also.

There is concern that the sub-contract market will be the ones to feel the full force of the Covid 19 fall out with many redundancies predicted. Along with falling margins to remain competitive, they are incurring the cost of extended hours to improve efficiency.

Similarly, head contractors are forecasting redundancies but are taking a more longer term positive view that the downturn of projects is as a deferment rather than an abandoning altogether and that 2021 will hopefully be more positive.

For consultants, fee levels are tightening but enquiry levels by clients for new commissions gives cause for some optimism.

The U.K. Cabinet had asked contracting parties to "play nicely". Initially, that is what happened with collaboration occurring between clients, main contractors, and sub-contractors to achieve practical, just, and equitable outcomes.

GPT's 32 Smith Street, Parramatta
Image by Slattery Quantity Surveyor
Tegan White, on a recent site walk

However, the reality of contractual implications is beginning to dawn with claims for delay and loss of productivity emerging.

Recommendations

The industry has proven over the course of the first lockdown that it can adapt successfully. There has been much collaboration across the sector, particularly between unions and employers to find workable solutions.

The lesson from the U.K. is that the focus for the industry now should be on how it opens in 6 weeks' time with a supply chain that has a minimal lag to on-site activity and prevents wasteful re-mobilisation costs.

Clients and their contractors should be seeking to place orders now before others get in first. If access to certain materials is time critical, then inter-state and overseas procurement will have to be considered if the premium is justified.

There will be a time lag for projects in other states relying on materials or manufacturing from Victoria. If that pressure to the programme cannot be absorbed, then the same alternative procurement paths will need to be explored and quickly.

Clients and contractors in the middle of tendering projects not just in Victoria but across the nation, may have to assess sub-contractors with a new lens, namely certainty on supply. Depending on the circumstances, it may be worth a premium for key trades.

We would also recommend that clients and contractors alike seek legal advice on the wording of their contracts and how it relates to delay costs and claims in relation to legislative changes.

Construction Pricing in Melbourne – What is the outlook?

In Slattery's previous June Market Update, we noted that competitive pricing had been observed, but there was not at that stage a 'race to the bottom' by contractors and the supply chain.

It has now been over 6 months since the emergence of Covid-19 in the Australian community and with a larger sample size of projects having recently returned from tender, some key insights have emerged.

Recent tender results support the view that construction pricing is sharpening due to reduced tender opportunities and a gloomy 12 - 18 month outlook. We are consistently seeing tender returns below expectations by between 5% and 15%. The range is dependent upon size and complexity.

Whilst this is a clear barometer of how Covid-19 has impacted the construction industry, pricing reduction is also partly due to a market correction. There have been significant and abnormal increases in the 2-3-year period prior to 2020 and there are many large projects close to completion with a smaller pipeline on the horizon.

Whilst engagement on tenders is far greater than pre Covid-19, contractors are still discerning with what they consider a 'must win' project to throw their full weight behind. We have seen far keener pricing in critical government sectors with projects that have the green light to continue.

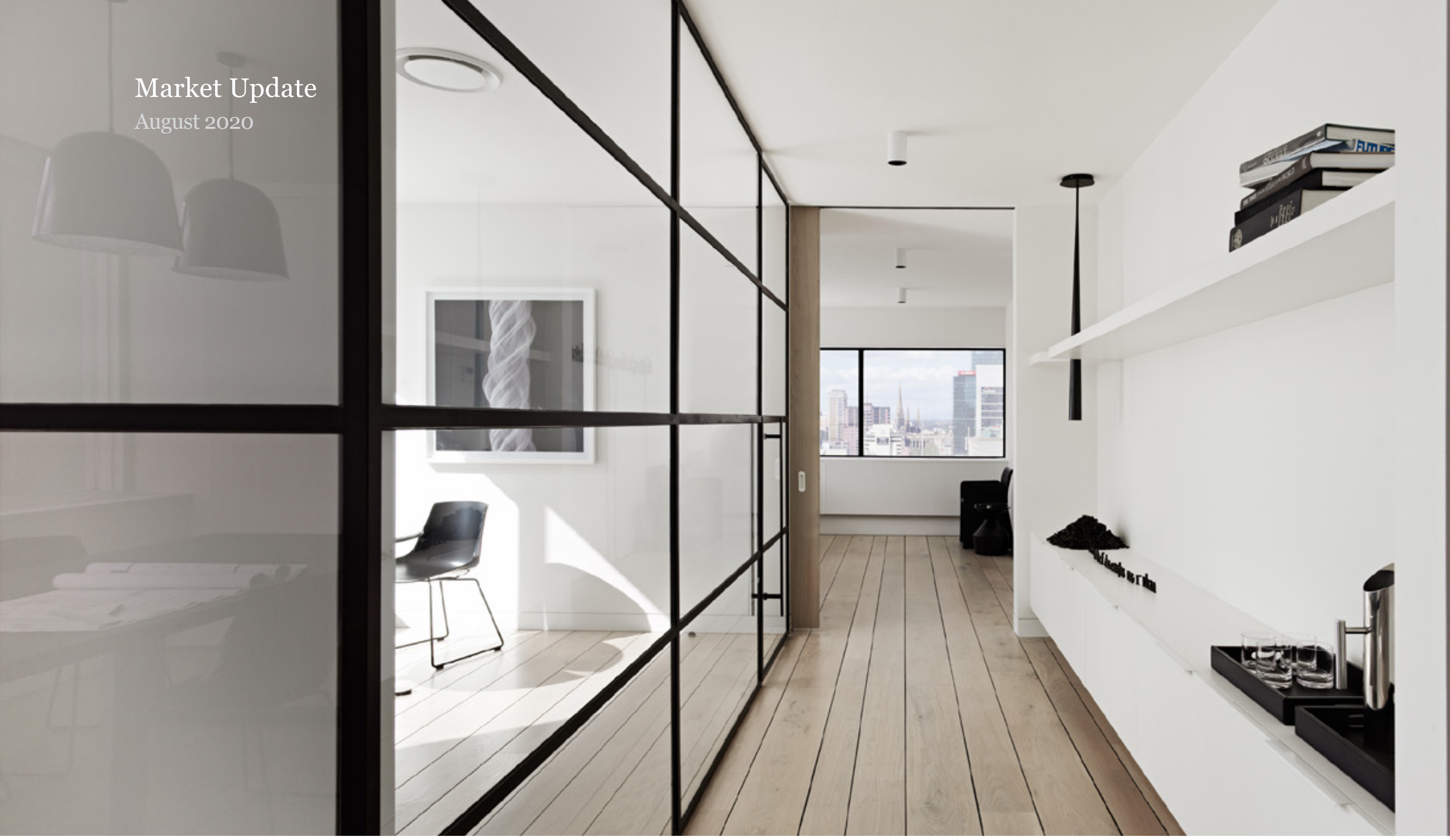
The subcontractor market has become far more engaged and tenderers are receiving much greater trade coverage. On one recent tender we understand that tenderers were receiving upwards of 10 prices across the services trades. Ordinarily this level of engagement would lead to a downward trend in pricing and we are starting to see this, however savings will be partially offset by any cost impact associated with Covid-19 (e.g. EBA's, loss of productivity, supply chain risk, etc.).

We are seeing significant competitiveness in contractors' margin and overheads. We have seen instances of contractors including margin at 1% or even zero to secure workload. Although that is not the norm many are passing on their expected trade letting gains at tender time to stay in the race.

Many trades are pricing under pre-covid levels. This has been most prevalent in the services trades, structural steel and joinery. Some trades such as concrete, precast and partitions have remained steady.

Whilst it is too early to predict exactly what impact the Stage 4 shutdown will have on construction pricing, it is not too far a stretch to say that it is likely to become very competitive as the number of tendering opportunities for the contracting community, its supply chains and design consultants, slows down.

Despite many of our Clients seeing the potential benefits of such a competitive market, our previous advice remains. Clients should be wary when tendering and do extensive due diligence on both head contractors and their sub-contractors and we urge caution in contracting at prices significantly below reasonable market rates.



About Slattery

Slattery is a property and construction advisory firm specialising in quantity surveying, cost management and early phase project advisory, with an outstanding history spanning more than 40 years.

We work hand-in-hand with governments, institutions and organisations as well as planners, developers, architects and design teams on a broad range of property and construction projects.

A commitment to excellence and innovation, and an ability to become an integral part of the project team has earned Slattery the trust and respect of clients and project teams alike. Slattery adds value by taking control and ownership of the cost management process from the outset. We understand the importance to drive innovation and productivity.

We invite you to explore our knowledge sharing further at www.slattery.com.au/thought-leadership