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National Market Update

Uncertainty in the Market, State of Play

May 2022

Uncertainty in the Market
State of Play, Australia Wide

2022 is unfolding as another year of uncertainty as post COVID stimulus, supply chain pressures, contractor liquidations, extreme weather events, geopolitical instability, and commodity price escalation all converge.

In this update, Slattery provides insights into how the construction market is responding to macroeconomic forces, continuing material increases, and contractor uncertainty. What impact does local and overseas instability have across Australia's construction market?

This paper covers cost escalation, procurement, and contractor stability, and provides a state-by-state overview.

Introduction: The cost escalation forecast and what it means

With new projects breaking ground and on-hold projects restarting after several lockdowns and long periods of uncertainty, Slattery is predicting a national average of 4-8% escalation over the next 12 months. While this is a wide range, much will depend on the local conditions and the type of project.

Due to various current market pressures, this is a distinct increase from Slattery's market update in December, which forecast a national average of 3-4%.

Smaller markets will continue to struggle to secure reliable supply chains and subcontractors, with Tasmania (12-15%) pushing the highest escalation, Perth (10-15%) closely behind, and Brisbane (6%) the third highest.

The industry's inability to attract labour resources and talent will continue to put pressure on pricing. Similarly, increases in steel and copper prices and timber shortages will drive costs upwards over the next six to twelve months.

Cover page:
Slattery Melbourne Office
Queen and Collins
Elenberg Fraser

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Overview of the key impacts on the national market

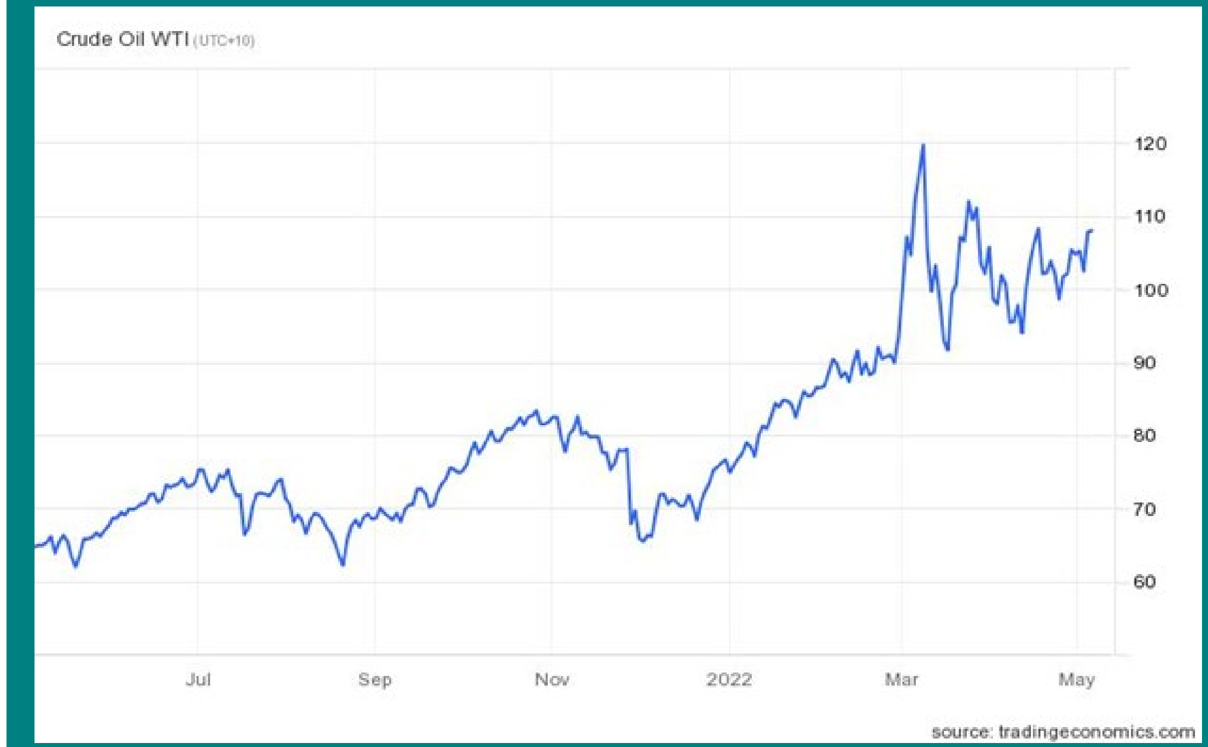
In delivering work across all Australian states, Slattery has observed significant price increases across most building materials. Below, we highlight the key impacts on material supply prices:

- **Shipping costs:** These costs are still under pressure and have increased by a reported 300% over the last twelve to eighteen months. There are signs, however, that costs are starting to stabilise with global prices declining since the end of February.
- **Joinery and façades:** Due to China's hardline stance on COVID-19 shutdowns and stay-at-home orders, quality control continues to be an issue for overseas joinery and façade manufacturers.
- **Steel:** The price of steel reinforcements, studs and structural steel has continued to increase over the last three months.
- **Copper:** Prices remain high, impacting supply costs for piping used in hydraulic and mechanical services and electrical power cabling.
- **Nickel:** There has been a reported 138% increase in nickel commodity prices over the last 12 months. This puts significant upward pressure on stainless steel prices.
- **Aluminium:** Feedback from the market indicates that steel and aluminium prices have risen 10% in just the last three months and could potentially continue rising. This is flowing through to façade pricing and structure costs.
- **General material availability:** There are concerns with material availability (at any price!) and what impacts this has on project programs and associated delay implications such as liquidated damages. This is being considered in the head contractor's commercial assessments for projects at the tender stage.
- **Energy:** There have been understandable concerns over oil and gas price spikes associated with the conflict in Ukraine. Economy-wide costs have ensued, as all sectors are impacted by increased energy and transport prices. Importantly, increased costs of living ultimately leads to pressure on wage growth, as people turn to their employer for a pay rise to offset those costs.

Labour Costs and Insurance

Labour costs and increasing contractor insurance premiums also pose potential impacts on the national market.

- **Labour costs:** Labour costs are generally well understood and locked in under the current enterprise bargain agreement (EBA) price increases, which is 4-5% per annum This translates to 2-2.5% on overall cost as an underlying escalation.
- **Insurance:** Feedback from multiple contractors indicates that their insurances are increasing. This has a knock-on effect of increasing preliminaries in the order of 0.5% of a project's value. Further increases of 0.5-1.0% of project values are forecast over the next twelve months.



Graph One
Crude Oil Prices
tradingeconomics.com

Overview of the key impacts on the national market

Adapting and evolving to market conditions while trying to maintain business stability has driven many contractors to change their operations and procurement processes. Examples are highlighted below:

- **ECI and partnership models:** In some Australian markets, clients are using early contractor involvement (ECI) and other forms of partnership contracting in a bid to lock in program and resources. However, this does come with a cost premium.
- **Rise and fall:** Some tenders are linking pricing to current commodity prices, exchange rates or supply rates to avoid taking the risk of a sudden price change throughout the program. Contractors are questioning the concept of 'rise and fall' contract clauses. Thought to be a relic of the past, these contract clauses allow the final project pricing to fluctuate in line with material prices and labour cost increases. But a widely accepted index or set of indices is required to adequately manage rise and fall contract provisions, and without the support of a federal government agency this could be a barrier to industry-wide acceptance.
- **Low margins and risk:** Over the past few years, contractors have absorbed more risk while offering lower margins to secure pipeline. To mitigate this, contractors on recent tenders are only offering a sixty-day price validity, and subcontractors are offering just thirty days. Contractors are then adding escalation to cover the gap. This means by the time a tender analysis is complete and recommendations have been made, the price is already out of date!
- **Hedging material supply:** Some larger contractors with greater purchasing power are stockpiling key materials to hedge against rising costs on long term projects. This results in an immediate short term cost premium in exchange for security of supply across the life of the project.
- **Insolvency:** In a rising market, there is an increased risk of contractor insolvency – and this theme is currently playing out in the press. ASIC data shows that insolvency figures are still less than pre-pandemic levels. However, the construction industry is a higher proportion of insolvencies across the overall market data.

The federal government implemented temporary relief measures for company directors' personal liability for insolvent trading in 2020. It would appear this reduced insolvency declarations. Government support like JobKeeper also propped up some businesses. The relief ended in March 2021, and insolvencies are rising but are still not back to pre-pandemic levels in the construction sector. There have been several high-profile construction insolvencies in the market, and this trend is likely to continue.

To minimise project risk, detailed financial checks are important to ensure the supply chain is solvent. Parent company guarantees cannot always be counted on, as we have seen recently. The ramifications of a head contractor insolvency, in terms of time and cost, can be significant. Sometimes the lowest tender price can be the most expensive.

Image credit:
The University of Tasmania's
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John Wardle Architects

The forecast

Slattery is forecasting an average of 4-8% per annum for the next twelve months in Australia's major markets. There will be significant variances in our smaller and more remote cities.

The national average is not consistent and will affect projects differently. After the next twelve months, we estimate that costs will revert to a long-term average of 3-5%.

> "We anticipate that the biggest impact will be on longer-term projects, in particular projects with budgets that were set years ago but are only now starting to proceed"

It is important that clients review their portfolio of projects to understand how they may be affected and to determine appropriate mitigation strategies.

Graph Three

Cost escalation forecast

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State by State: Common Trends

While many impacts are common nationally, each state faces local impacts, opportunities, and challenges.

Queensland

We continue to forecast escalation at 5-6% for the next twelve months. This is based on several key factors:

- **Market pressure:** The Queensland construction market has seen significant price increases over the past twelve months. This has been driven by material shortages and price increases, shipping costs and skilled labour shortages. This increase in cost has put pressure on contractor and subcontractor cashflows and balance sheets, with many reporting losses on their projects.
- **Conservative contracting:** Unfortunately, companies have gone into administration and others are taking a conservative approach to new work and are unwilling to risk tendering a Design and Construct fixed-priced contract. Instead, many are preferring to partner and negotiate with long-term clients and share the associated risks. Documentation needs to be 80% or more for contractors to consider tendering, enabling them to lock in subcontractor and supplier prices.
- **Unpredictable cost pressures:** There was optimism at the beginning of this year that the factors driving costs would settle down and costs would normalise by mid-year. However, since then a major rain event and the subsequent flood has driven more demand for tradespeople. Meanwhile, the fallout from geopolitical events is beginning to take hold, with pressure at the fuel bowser just one illustration.
- **Slowdown ahead:** Construction costs at the current levels are now affecting developers' feasibilities and clients' budgets. This will inevitably result in a slowdown in demand as projects will not be financially viable.

Victoria

Victoria, and in particular Melbourne, is a very uncertain contractor market. The underlying cost escalation is 4%. However, some sectors will have 5-8% depending on the typology and size. Key factors include:

- **Victorian State Budget:** Health spending was the centrepiece of the 2022/2023 State Budget. With more than $12bn committed for more health professionals, services and infrastructure, the government aims to alleviate pressure on the system. Currently, there are over 90,000 Victorians awaiting elective surgery, 000 calls are growing and there is increased demand for hospital beds across the state.
- **High-profile liquidations:** The recent collapses of Probuild, Grocon and ABD Group highlight the ongoing importance of detailed financial due diligence at all tiers of contractor.
- **Supply issues:** Victoria is challenged with the same material and commodity supply issues that face the rest of Australia. Plasterboard, steel (structural, reinforcement and sheet), aluminium, timber and curtain walling are pushing prices up and well above historical benchmarks.
- **Escalation spectrum:** It is important to assess specific project factors to understand where each project fits within the above 5-8% escalation spectrum for Victoria:
  - Is the contractor's pricing in risk based on current uncertainty?
  - What sector impacts can be expected? Projects with large proportions of some materials will see the biggest movement. For example, a large warehouse predominantly of steel will see large price increases.
  - Does the current budget allow for escalated rates or was it set prior to the start of 2022?
  - Are there sufficient contractors capable and interested in the type and scale of the project?

New South Wales

Our forecasts escalation range for the next twelve months is 4-8% and will be very project-dependent. Beyond the next twelve months, supply chains will likely start to normalise and, assuming no further impact of global events, we would expect escalation to be between 3-5%. Key factors include:

- **Material price uncertainty:** Nobody knows what will happen with material pricing in the short term and contractors are very worried. There have been significant increases across the board over the last twelve months. In Sydney, market supply and demand fundamentals are within historical norms. The current price pressure is driven by supply chain issues rather than labour or margins. Contractors are all still looking to fill order books, so margins remain competitive. However, contractors are starting to question historical margins with the recent influx of insolvencies.
- **Insolvency pressures:** Contractor feedback indicates concern that suppliers will not hold prices for subcontractors even on 'locked in' contracts. There is further concern this could lead to increased insolvency pressure in the subcontractor market, particularly on long term contracts.
- **Flood bounce back:** The impact of flood relief works is also expected to put upward pressure on costs. The initial estimate of the damage repair is $1-2 billion. State and federal governments are likely to deploy funding to infrastructure impacted in the affected areas and will likely look to fast-track projects with managing contractors or similar procurement arrangements.
- **Sector-by-sector story:** Commercial, retail and residential sectors remain subdued in NSW, although there is a strong commercial pipeline ready to go to market if tenant conditions improve. Education, health, industrial and infrastructure are currently driving the market.

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Western Australia

Although the market has shown some signs of stabilising, escalation in Perth is expected to run at approximately 8-8.5% for the next twelve months. However, the escalation on projects where contractors are taking on Design and Construct risk is now ranging between 10-15%. Several factors are at play:

- **Labour shortages:** The expected influx of labour and skilled professionals as border restrictions ease has been slow to materialise. This has stalled some projects that were scheduled to commence as concerns over delivery capacity influence decision making.
- **Various work-winning strategies:** There is a diverging risk appetite observed in the Tier 2 contracting market. Contractors with full order books, or those that have reached a 'safe' point, are being more cautious in their risk assessments and less aggressive in their bidding strategy. Conversely, those who remain short of their necessary targets are retaining a more aggressive approach to their work-winning strategies.
- **Materials prices:** Steel prices are starting to vary widely. Smaller and less complex orders are holding at reasonable pricing while larger and more complex orders are suffering. Specialists and suppliers are increasingly finding it difficult to maintain local stockpiles as demand is exceeding supply of available materials.
- **Sector opportunities:** The workplace (fit-out and refurbishment) sector is showing continued resilience even with the much-reported drop in CBD footfall. There are, indicatively, considerable resources being expended to improve the appeal of returning to the office with end-of-trip and amenity upgrades continuing within the CBD.

Tasmania

Tasmania has experienced movements more than the national average. Construction costs have increased in the order of 10-12% over twelve months to December 2021. Forecasts are at more than 15% in 2022 and 10-12% in 2023. Key influences include:

- **Market conditions:** A significant commercial, residential and infrastructure construction boom is forecast due to population growth and investment. COVID did not influence this growth with the government injecting more stimulus projects into an already overheated market. Residential demand continues to grow exponentially based on historical shortages, more stock allocated to short term-stays and COVID-induced population growth resultant as former residents return and families look for safer environments.
- **Labour shortages:** Construction activity in Tasmania through 2021 increased significantly on 2020 with several large-scale commercial and infrastructure projects coming to the market, and residential development continuing at pace. This would appear to be an increase of 20 to 30% on 2020 (noting this accounts for projects that either slowed or stopped in 2020 during COVID shutdowns).

The expectation is for growth in the order of 15-20% in 2022 and 2023. The labour market must be bolstered to meet demand, with around 10,000 new workers required. Labour from interstate is not likely to fill this hole during '22 due to the recent flooding and recovery now required in QLD and NSW.

- **Market demand and opportunistic pricing:** Tasmania has access to a limited pool of Tier 1 contractors and subcontractors in specialist trades. Therefore, an increase in margins at all levels is anticipated, with some trades at an additional 5%. Margin increases are not necessarily opportunistic, but are in response to increased risk from COVID related contract conditions and lack of escalation provisions. In addition, suppliers are requesting upfront payment for materials that then places extra demands on cashflow and often requires additional borrowing.

South Australia

In South Australia, escalation is predicted to be at least 4% over the next twelve months. Key influences include:

- **Material shortages:** The market is very busy with material shortages reported in most trades, in particular insulation, steel, timber and plasterboard. These material shortages are resulting in program issues as well as an upward cost pressures. These challenges are being felt across both the residential and commercial building sectors.
- Government projects: State government capital works are at an all-time high with the new Women's and Children's Hospital, a redevelopment of the Queen Elizabeth Hospital, a potential new stadium, a sports institute, and significant works at Flinders University.
- Sector stories: The education sector is busy with spending across a program of projects. There are also large defence projects due to come to tender in the short term. The private sector is also buoyant with North Adelaide and Port Adelaide being hot spots for medium density residential.

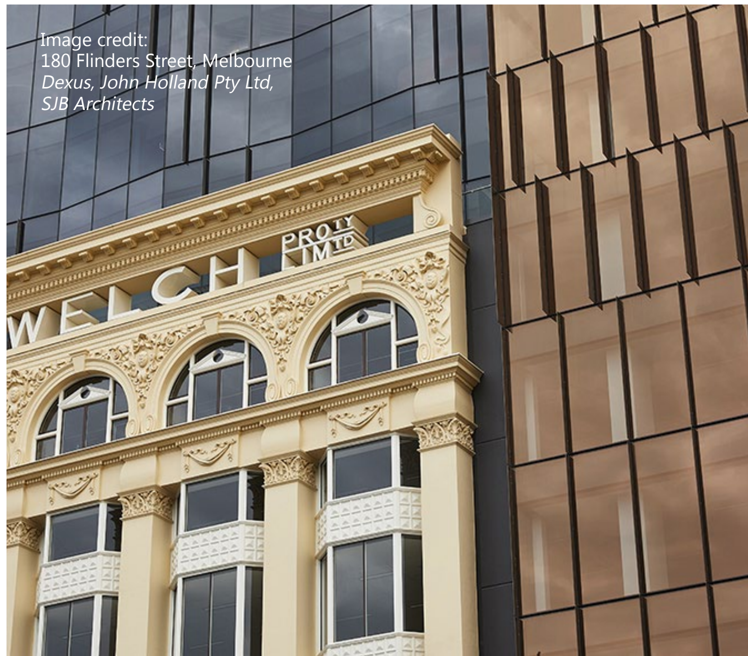

Image credit:
180 Flinders Street, Melbourne
Dexus, John Holland Pty Ltd,
SJB Architects

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32 Smith Street, Parramatta
Richard Crookes Construction,
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About Slattery and our collaborators

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

Thank you to **Peter O'Donoghue from Exsto Management** and **Chris Sale from Chris Sale Consulting** for contributing to this Construction Market Update with on the ground knowledge of the market in Tasmania and South Australia respectively.

Slattery Carbon Planning

Slattery is proud to be the first Quantity Surveying firm in Australia to launch a Carbon Planning service.

This new service is available in conjunction with Cost Planning to assist our clients in achieving their Net Zero and sustainability targets. The focus of the carbon plan will address and educate clients on the embodied carbon of their current and future developments.

Read more about Slattery's Carbon Planning offering at https://slattery.com.au/services/carbon-planning-measuring-embodied-carbon/

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