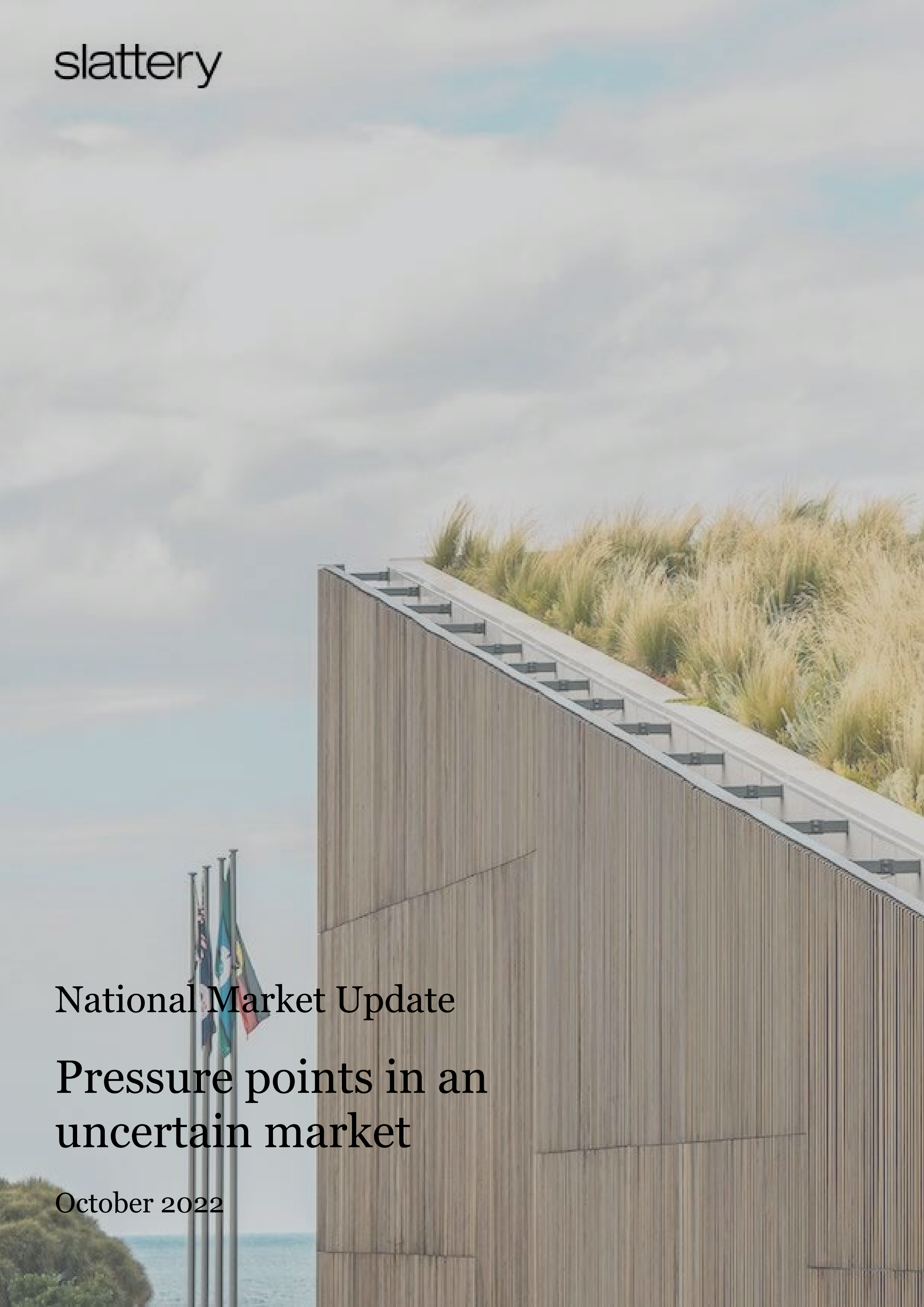

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National Market Update

Pressure points in an uncertain market

October 2022

Pressure points in an uncertain market

Volatility and uncertainty characterise the state of play for Australia's construction industry over the last six months as the world emerges from the Covid-19 pandemic. Supply chain pressures, geopolitical turmoil, soaring commodity prices and two years of pent-up demand for projects are translating into cost increases across all markets and sectors.

Overview

In this update, Slattery examines how Australia's construction market is responding to macroeconomic forces and market-specific issues. We cover primary cost pressures and provide a state-by-state commentary.

After two years of relative inactivity, Australia's construction markets are booming. Projects that had been shelved or in 'go slow' mode are now being ramped up or going out to the tender market. But labour costs continue to rise, placing extra pressure on budgets and programs.

Domestically, six interest rate rises in as many months have dampened consumer confidence. Australian petrol prices have skyrocketed in 2022 and will jump by another 20-plus cents when the federal government's excise cut ends.

However, domestic factors are overshadowed by international forces outside Australia's immediate control. This ranges from protracted conflict in Ukraine to China's Covid-zero strategy to the US Federal Reserve's war on inflation which could set the world on a path to recession.

In early September, Reserve Bank Australia governor Philip Lowe noted the "narrow path to a soft landing" for the Australian economy.

Cover page:
UTAS, Cradle Coast Campus, TAS
John Wardle Architects in collaboration with Philp Lighton Architects, ASPECT Studios & Room 11

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Ashurst, Canberra, ACT
FDC Construction
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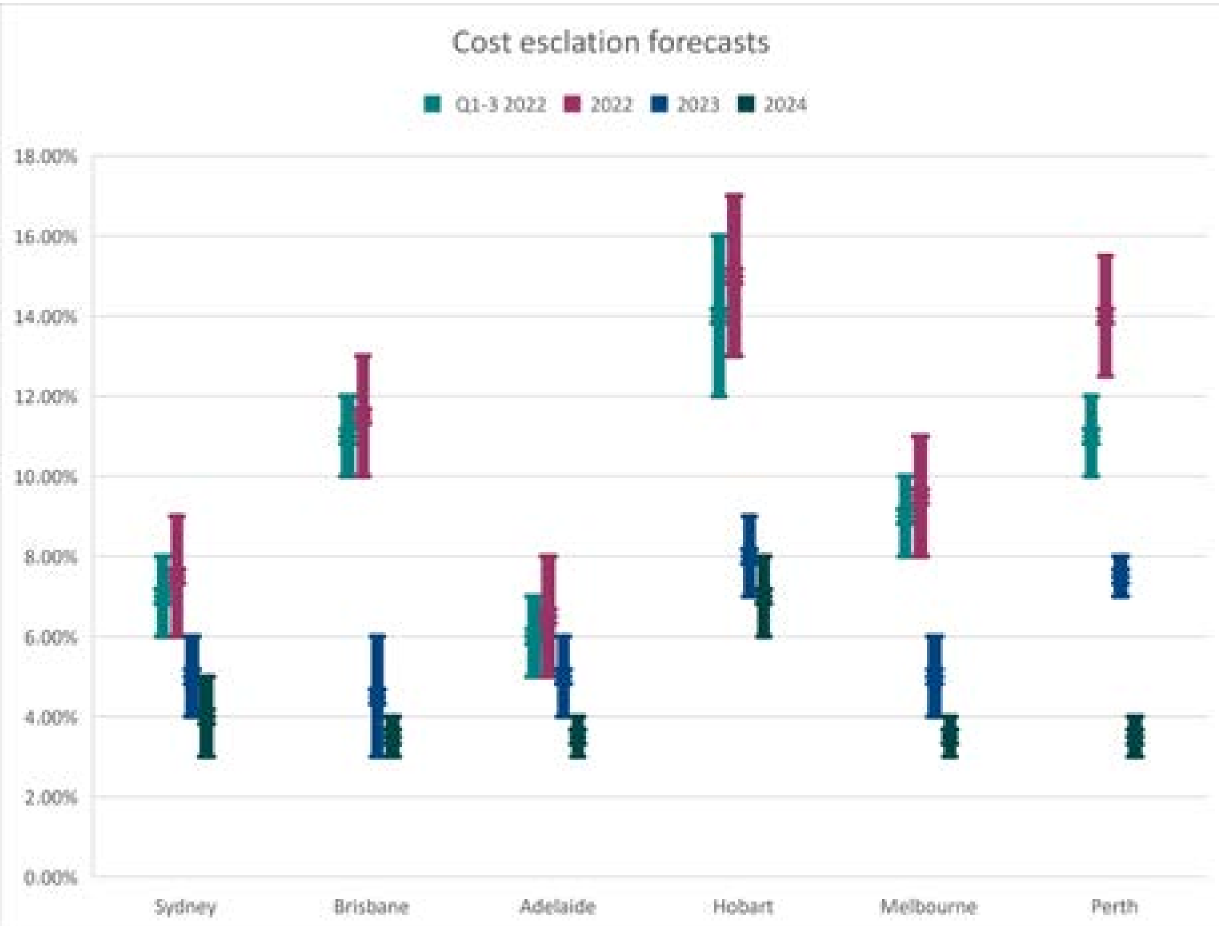
The forecast

Slattery is forecasting an average of 4-6% for the next 12 months in Australia's major markets, although smaller and more remote cities can expect significant variances. This national average does not apply consistently to all projects, materials or locations.

Looking further into the future, we estimate that costs will revert to a long-term average of 3-4% in 2024. We recommend clients review their portfolio of projects to understand the impact of cost escalation and adopt appropriate mitigation strategies.

Slattery's team of cost experts predicts costs will normalise over the course of 2023. However, the unpredictable events of the last 12 months – from major rain events and floods to the fallout from war in Ukraine – demonstrate the precarious nature of cost predictions.

City	Last 12 months	Remainder of 2022	2023	2024 and beyond
Sydney	6-8%	0-1%	4-6%	3-5%
Melbourne	8-10%	0-1%	4-6%	3-4%
Brisbane	10-12%	0-1%	3-6%	3-4%
Perth	10-12%	2.5-3.5%	7-8%	3-4%
Adelaide	5-7%	0-1%	5%	3-4%
Hobart	12%+	1-2%	7-9%	6-8%



Source:

Slattery 2022

Key national impacts

International influences

Energy price hikes over the last two years have been the largest since the 1973 oil crisis. The war in Ukraine dealt a major shock to commodity markets, recalibrating global patterns of trade, production and consumption and sending prices to historically high levels until the end of 2024, according to the World Bank [1].

Meanwhile, the Chinese Government continues to pursue a "Covid-zero" strategy. In recent weeks, tens of millions of people have been confined to their homes in lockdowns across 60 towns and cities, including in manufacturing hubs like Shenzhen and Tianjin. When China, the world's factory floor, is in lockdown, supply shortages are inevitable.

Materials

Volatility in supply chains continues to influence pricing of materials. But we are starting to see prices for some materials, notably steel, plateau. Price increases are now aligned with the volume of work in the market, rather than international supply chain bottlenecks. Notable influences on costs include:

- **Shipping:** From historic highs, shipping container costs have fallen with analysts predicting the container shipping industry is set for a 'short, sharp, hard landing' [2].
- **Steel:** Steel prices are down more than 45% this year amid a slowdown in economic growth, a rise in inflation and ongoing supply-chain problems. The price of reinforcement steel or rebar, for example, has fallen by 20% over the course of 2022.
- **Timber:** Timber prices are now around two thirds lower than at their peak, but the collapse of lumber prices could be a harbinger of a recession to come.
- **Copper:** Prices have been in steady decline since their March high. While this brings down the cost of piping and electrical power cabling, copper is considered a dependable barometer of economic health and falling prices could be another bad omen for the global economy [3].

Labour costs and skills shortages

Skills shortages are not isolated to the construction industry. The federal government's Skills Priority List shows that 286 assessed occupations are now in national shortage, compared to 153 occupations in 2021 [4]. Following the Albanese Government's September Jobs and Skills Summit, the cap for 2022-23 permanent skilled migration was raised to 195,000 from 160,000 places. Further announcements are expected in the second Federal Budget handed down on 25 October 2022. An increase in migration will attract more skilled labour.

Construction labour costs are locked in under the current enterprise bargain agreement (EBA) price increases, which is 5% each year This translates to 2-2.5% on overall cost as an underlying escalation.

However, with labour at a premium for both trades and professional services, labour costs remain well above expectations. We expect costs for some trades will ease as the volume of work slows in 2023.

Meanwhile, construction companies are grappling with the concept of the five-day week. Several builders are now offering this to clients and in May, the NSW Government began asking builders to tender for projects on a five-day and six-day working week schedule [5]. How this impacts productivity over the long term remains to be seen.

Image credit:
New Student Precinct
Art & Culture Building
University of Melbourne

Net zero and sustainability

The federal government has passed legislation enshrining a 43% reduction in emissions, based on 2005 levels, by 2030. Net zero and sustainability targets have evolved from aspirational to a minimum requirement.

Conversations around the circular economy and ESG, once held on the margins, are now moving to centre stage as Australia's property and construction industry begins to drive down emissions at speed.

The emissions generated upfront during construction are looming as a costly challenge. In the short-term, construction businesses will be reliant on carbon offsets, but Slattery's calculations suggest just one medium sized commercial office building could face a bill for carbon offsetting to the tune of $6.6 million [6].

Another large challenge is to retrofit existing buildings. The City of Melbourne, for instance, estimates that meeting its citywide net zero targets will require electrification retrofits of 77 large commercial buildings each year – an 11-fold jump from the current average of seven [7].

The cost of carbon is just one of many ESG considerations, as modern slavery, ethical sourcing, diversity, and inclusion also attract headlines and headspace. Traceable materials and transparent reporting increasingly underpin consumer trust – but this comes at a considerable cost.

CBD reactivation

Australia's central business districts are yet to fully bounce back to their pre-pandemic vitality. The Property Council's latest office occupancy figures, for September 2022, show Melbourne (39%), Sydney (53%), Brisbane (57%), Perth (69%) and Adelaide (71%), all have significant room for improvement [8]. The nighttime economy also remains $6.2 billion below the pre-pandemic baseline, according to the Council of Capital City Lord Mayors [9].

Office occupancy rates vary between peak and low days, and we expect the gravitational pull of the CBD office to be stronger in 2023. But we also expect many asset owners to begin to reimagine their lower-grade office stock.

Contractors balance risk and reward

We continue to see contractors weigh up the risk and reward of many projects. The volume of work currently in the market is such that contractors are spoilt for choice. Large projects are not necessarily an incentive on their own anymore, and many builders are no longer prepared to take a risk on projects with a long-term horizon and hazy cost estimates.

> “The federal government has passed legislation enshrining a 43% reduction in emissions, based on 2005 levels, by 2030”

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State by state: Common trends

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

New South Wales

Our forecast escalation range for the next 12 months is 4-6%. But as supply chains normalise we expect escalation to be between 3-5% in 2024. Key factors include:

- **State election:** With the next state election set for 25 March 2023, uncertainty around future funding of some infrastructure and large building projects could have an impact. However, there are unlikely to be material changes to investment in mega-projects, such as Sydney Metro.
- **Labour shortages:** Consultant firms have struggled with recruitment and retention of staff for the last 12 months, but this is starting to ease. Skills shortages continue to plague the industry, and federal government policy to encourage migration, notably the increase in the permanent migration program, is welcome [10].
- **Floods:** We continue to see very high pricing and massive labour shortages in the state's north. In some cases, we are seeing trade prices come in at double the expected rate. Across trades, we have seen a jump of 15-20% in quoted prices over the last year. However, we are seeing prices fall at the tender stage.
- **Wet weather:** Sydney has experienced one of its wettest years on record, and this is placing builders under extra pressure as they wear the extra costs [11]. This is impacting existing contracts, but has not translated into additional cost implications for our clients because builders have priced this into their contingencies.
- **Office market:** CBD office occupancy – the number of people sitting at their desks each day – remains at 53%, according to the Property Council [12]. However, we continue to see the flight to quality play out as tenants upgrade from B and C grade stock. Many building owners are now considering the highest and best use of that older stock, and we expect to see a flurry of feasibilities of adaptive reuse projects into hotels and residential apartments.

We are increasingly seeing sub-contractors less willing to take on risk, especially on complex projects. Pricing on low-risk, easy jobs are coming in as projected, while jobs with high-risk profiles are far exceeding expectations. However, main contractors are beginning to look for work from 2023 as their pipelines dry up. While this has not yet flown downstream to subcontractors, it inevitably will.

In September the NSW Government published new commercial principles for procurement, which recognised that contractors cannot continue to bear price escalation risk on projects [13]. While this is a high-level roadmap that will influence the market at a slow pace, we believe this will have cost implications over time.

Image credit:
87-91 George Street, Parramatta
Bates Smart

Victoria

After two years of unpredictability, Victoria's market is on the move. Projects previously shelved are now out for tender, while others on go-slow have started to speed up. Contractors are busy and we expect an underlying cost escalation of 4-6%. Looking further afield, we expect the market to slow over the course of 2023, with costs falling back to 3-4%, the traditional long-term average, in 2024.

Key factors in the Victorian market include:

- **Office market:** Despite office occupancy in Melbourne's CBD still at 39% of pre-pandemic levels [14], and office vacancy across the city at 12.9% [15], we are seeing several developers scoping out sites and looking to build new stock. While this may seem counterintuitive, the tenant 'flight to quality' is driving demand for healthy, high performing buildings. We expect to see several buildings in the CBD go out to tender in the next few months. We are also seeing several proposals for office buildings in city fringe locations, with REITs beginning to play in these markets, notably in the Richmond/ Cremorne tech hub which is being positioned as a 'mini Silicon Valley'. However, some of this market interest is more in response to lack of available development sites in the CBD.
- **Build-to-rent:** The Victorian Government gave this new asset class a leg up when it halved land tax concessions on eligible projects. This, combined with the number of sites available in attractive locations, has seen Melbourne claim the lion's share of national BTR projects [165]. With the Real Estate Institute of Victoria recording a 3.6% vacancy rate in August, demand for rental is strong [17]. Government incentives, especially to encourage social or affordable housing allocations, may be required.
- **Government projects:** The Victorian Infrastructure Plan 2021 outlines an average of $22.5 billion in government infrastructure spending each year over the decade ahead [18]. With the state election on the horizon on 26 November, infrastructure spending promises from all parties maintains market buoyancy. While a change in government, although unlikely based on current polling, could change infrastructure priorities, we expect investment in roads, rail, hospitals and schools to continue to create work.
- **Labour shortages:** Before the COVID pandemic Victoria was the fastest growing state in the nation. But during the year 2020/21 Victoria's population decreased by 44,700 people. While the brain drain has had an impact on labour costs, we believe cost escalations are weighted more towards supply, following two-years of pent-up demand.

We are seeing more clients entertain early contractor involvement to secure resources and program. ECI does come at a premium, but the client is choosing this model to gain certainty around delivery. This is occurring across all scales of projects, as developers buy not only expertise, but certainty.

Queensland

Costs have risen by up to 20% in just 18 months. Prior to this, market uncertainty kept a lid on prices. But material scarcities, shipping costs and skilled labour shortages have placed pressure on contractor and subcontractor cashflows and balance sheets, with many reporting losses on their projects.

Costs climbed by 3-4% between April and October 2022, and there was some expectation that the market would cool over the next six months.

Queensland's cost escalation is influenced by factors affecting all other markets, but there are several location specifics worth noting:

- **Labour shortages:** Queensland attracted the highest net migration rates in the country in 2021. Domestic migration and homeowners with high levels of equity have driven the renovation market through the roof. The pool of skilled trades in Queensland is small and subcontractors, in particular, have struggled to secure labour.
- **Olympic Games:** Brisbane's Olympic Games is still a decade away and is not yet impacting building work. However, it has proved a clever marketing campaign for the sunshine state and is attracting domestic migration. The message to trades is that work is plentiful, and costs will keep trending upwards.
- **Risk aversion:** The newspaper headlines in Queensland read 'inflation, inflation, inflation', driving conservative contracting through the subcontractor market. Risk aversion is also permeating the insurance market. Slattery clients have reported that contractor risk insurance has doubled in just two years.

We expect the residential market to cool as developers' budgets and feasibilities no longer stack up. Builders have now heard this message and are beginning to price accordingly. Trades, busy with work secured 12 months ago, are yet to respond – but we do expect a market slowdown in the residential sector will influence their prices.

However, state government infrastructure projects – including a $10 billion hospital pipeline – are expected to be released in the next six-to-12 months. This will again fuel the subcontractor market, and for this reason, if the work goes ahead, we expect costs to escalate by 5-6% over the next 12 months.

Western Australia

After two years of market volatility, cost escalation is now predictable. The market has accepted a new definition of stability – one where prices rise on a steady trajectory rather in wild swings. We expect a 7-8% cost increase over the next six months.

Costs in Western Australia's market bear several unique characteristics:

- **Resource sector boom:** The mining sector makes up 75% of the construction market and the current boom has diverted most human and material resources away from non-resources construction projects.
- **Government spending bonanza:** The Western Australian Government is spending $10 billion on public infrastructure projects next year – 80% of that on transport projects – that will absorb a large proportion of the state's labour pool.
- **Tyranny of distance:** Construction projects tend to fall into one of three categories: remote resources projects; infrastructure programs focused on metropolitan Perth and the state's South West; or building works heavily focused on the metropolitan area. The availability of work in the city and the strong resources sector has resulted in an increasing proportion of public projects outside metropolitan areas that close with no tenders offered.
- **Capacity caps:** 40% of infrastructure contractors are at 90% capacity, or more, which hampers their ability to take on new work
- **Material shortages:** Key materials, like concrete, have been dominated by a small number of local suppliers. Pressure is starting to ease since more of the state's contractors began sourcing materials from outside the local market. For the first time in two years, we have noted significant sub-contractors actively seeking new projects for early 2023, which is a good sign for the market.

Many market players, notably those in the residential sector, have recognised that prices are unlikely to fall and are now firing up projects previously put on ice. In the residential sector, where the cost of construction is no longer being offset by value uplifts, developers are incentivised to start work on new projects sooner rather than later.

South Australia

Cost escalation over the course of 2022 stands at between 5-7%. We expect a 5% escalation over the next 12 months as clients accept cost escalation as part of the 'new normal'. Key local market influences include:

- **Government projects:** Historic levels of state government investment, including the $3.2 billion new Women's and Children's Hospital, the $314 million redevelopment of the Queen Elizabeth Hospital, the $200 million Aboriginal Art and Culture Centre and the $97 million Adelaide Botanic High School. The City of Adelaide's expansion of the Central Market began in June. These city-shaping projects continue to drive market activity [19]. We are seeing skills and labour shortages as a result of this heated market.
- **Private sector buoyancy:** Large projects in the private sector continue at pace, including Walker Corporation's 40,000 sqm Festival Tower and Charter Hall's 43,600 sqm 60 King William Street office developments. North Adelaide and Port Adelaide remain hot spots for medium density residential.
- **Volatile trades:** The market is reporting materials and skills shortages across most trades, notably civil, carpentry, plasterboard, joinery, roofing, cladding and architectural precast. Interstate projects are keeping local precasters busy, for example, which places upward pressure on local programs and costs. These challenges are being felt across both the residential and commercial building sectors.

Adapting and evolving to market conditions while maintaining business stability remains a challenge. The Department of Infrastructure and Transport is beginning to incorporate 'rise and fall' contract clauses and has backdated some costs relating to commodity price increases, exchange rates or supply rates. This recognises that risk must be shared more equitably between client and contractors.

Tasmania

The primary attribute influencing costs on the island state is market supply and demand. As the impact of rising oil costs, foreign sourced materials like timber, and currency fluctuations ease, we expect labour constraints to be the largest influence on cost escalation in the year ahead.

Based on the preceding 12 months, we estimate escalation over the next six-to-12 months at an average of 12%. Our previous estimate of 12% was validated by Master Builders Tasmania's own independent research. Looking further ahead, we expect conditions to soften and costs to pull back to a 8-10% range. Key influences include:

- **Construction activity:** Tasmania was already poised for a commercial, residential and infrastructure construction boom prior to Covid-19, due to significant public and private sector investment. The pandemic did not pause delivery of the investment pipeline and subsequent Covid stimulus programs have fuelled an already over-heated market.
- **Labour shortages:** Being an island, Tasmania has a limited resource pool and has historically relied on other markets for fly-in, fly-out labour. As mainland markets become resource-constrained, costs for labour on Tasmanian projects has escalated. Pressure points in several trades, notably plastering, mechanical and electrical, are causing program delays. In some finishing trades, like tilers and vinyl layers, costs are coming in at double the expected rate.
- **Professional services:** Some professional services remain competitively-priced. There is a large pool of local architecture firms for smaller projects, for instance, while clients of larger projects tend to turn to national firms. However, structural designers are scarce and we are seeing a three-to-four month lag on normal timelines. This can compromise quality of documentation and the tendering process, in turn influencing contractor risk assessments and adding an additional overlay of cost increases to projects.

Conclusion

Given the market uncertainty, many contractors are now carefully weighing up potential risks on many jobs. In the sub-$10 million category, for example, it is not uncommon to receive just one tender response. Opportunistic pricing among some contractors has seen margins increasing anywhere up to 10%.

In response, clients have accepted they must shoulder more risk and are moving to collaboration-based methodologies to ensure a fairer allocation of risk.

> "Our previous estimate of 12% was validated by Master Builders Tasmania's own independent research"

Image Credit:
UTAS, Cradle Coast Campus, TAS
John Wardle Architects in collaboration with Philp Lighton Architects, ASPECT Studios & Room 11

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Slattery Sydney Collection

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, Director** from **Exsto Management** and **Travis Swigart, Managing Director** 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.

Our 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 www.slattery.com.au/carbon-planning

Our team is pleased to hold memberships to the following industry groups:

AIQS | MECLA | Green Building Council Australia

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