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Slattery National Market Update

Economic headwinds blow

March 2023

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The current market is characterised by changing supply and demand dynamics. Economic headwinds are blowing and there is some nervousness in the market that we expect will play out from mid-year onwards.

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.

With Covid-19 measures easing in early 2022, most analysts expected economies to be recharged as supply chain snarls untangled and consumer confidence rose. However, global optimism was eroded over 2022 following Russia's invasion of Ukraine, the subsequent energy crisis, China's sustained zero-Covid policy and the ensuing supply chain implications. We entered 2023 with the International Monetary Fund suggesting a global recession may be coming our way as the result of rampant inflation and rising interest rates.

The forecast

Slattery is forecasting an average of 4-6% over 2023 in Australia's major markets, although significant variances can be expected in smaller and more remote cities. The national average does not apply consistently to all projects, materials or locations.

Looking further afield, we expect the market to revert to the traditional long-term average of 3-4% in 2024. However, cost predictions can be precarious, especially in globalised markets. Because of this, we recommend clients analyse their portfolio of projects to understand the impact of cost escalation and adopt appropriate mitigation strategies.

City	2022	2023	2024 and beyond
Sydney	6-8%	4-6%	3-5%
Melbourne	8-10%	4-6%	3-4%
Brisbane	10-12%	5-7%	3-5%
Perth	10-12%	4-6%	3-4%
Adelaide	5-7%	5%	3-4%
Hobart	12%+	7-9%	6-8%

Key national impacts

Australia ushered in the year with inflation at its highest level since 1990. March saw our tenth interest rate rise in as many months, and the Reserve Bank of Australia board has foreshadowed further increases. Against this backdrop, construction costs have continued to climb.

Insolvencies are now the big issue to watch, as construction companies grapple with the impacts of multi-year contracts signed well before costs escalated. Many large builders continue to operate on modest margins, and several have entered 2023 carrying legacy priced jobs. Some pandemic pricing hasn't quite washed its way through the system yet, and this could deliver further pain to subcontractors.

Market consolidation could be ahead, as well as a shift in contracting models that rebalance the risk that currently sits squarely with contractors. We are increasingly seeing sub-contractors less willing to take on risk, especially on complex projects. Pricing on low-risk, easy jobs are as projected, while jobs with high-risk profiles are exceeding expectations.

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Materials

Infrastructure Australia's 2022 Infrastructure Market Capacity report, published on 14 December 2022, found the cost of some construction materials had risen by an average 24% in just 12 months.

However, supply chain volatility has eased and prices for some materials, notably steel, have plateaued. Price increases are now more closely aligned with the volume of work in the market. Notable influences on costs include:

- **Shipping:** With a spike in demand for shipping services, carriers reaped record profits during the pandemic. However, we've seen prices fall alongside a drop in the import of retail goods. Long-term contract rates at the close of 2022 were down around 20% on the $8,000 per container cost at the pandemic's peak. Some analysts expect contract rates to halve in 2023.
- **Metal:** Global steel prices are expected to stabilise over 2023. By December 2022, steel had fallen more than 40% from April 2022, when it peaked at US$1,000 per tonne.
- **Timber:** Timber prices remain volatile, with fluctuations in the costs of structural timber in particular.
- **Energy and fuel:** Fuel price hikes continue to impact transport and delivery costs. Boral's energy and fuel costs rose 54% in 2022, with the company's CEO recently noting that "price erosion is not an option".

Extreme weather

The flooding that swept through Australia's southeast in February and March last year were the world's second-costliest natural disaster of 2022, according to global reinsurer Munich RE. The torrential rainfall that ravaged the country again in October, while not as severe, caused additional losses. Munich RE puts the damage bill at $11.6 billion, of which $6.7 billion was insured.

The cost impacts of these extreme weather events are wide ranging. Labour costs have climbed in regional markets where skilled trades are in short supply. We are also seeing increased costs for concrete, plastering and mechanical contractors in response to demand. Other costs are less obvious. For instance, demolition and in-ground costs are rising rapidly, particularly in Melbourne's CBD, due to waterlogged ground that is more difficult to extract.

Key national impacts *cont.*

Labour and skills

While material costs have risen sharply, it is labour scarcity that is causing the biggest headaches for construction companies.

Last year the federal government lifted the annual permanent migration intake to 195,000 places in its 2022-23 migration program. This opened doors to an extra 35,000 migrants to plug the country's pressing skills shortages.

As of October 2022, public infrastructure projects, including small capital projects, faced a shortage of 214,000 skilled workers. Infrastructure Australia expects labour demand to increase by 42,000 to a peak of 442,000 in 2023 – more than double the projected available supply.

The latest data from the Australian Bureau of Statistics says 29% of construction businesses have job vacancies – up from 23% the previous year. With labour at a premium for both trades and professional services, we expect these costs to remain well above expectations in 2023.

Meanwhile, the Electrical Trades Union is pursuing annual pay rises of at least 5% in negotiations with employers this year, as union leaders point to the 32-year high inflation rate and cost-of-living crisis.

CBD revitalisation

The Property Council's February 2023 Office Market Report showed average vacancies in Australia's CBD had climbed to 12.5% - up from 12% six months previously. Demand for office space increased by a tiny 0.1%, but national sublease vacancy has fallen – a healthy sign which suggests more companies are fully using their existing space. Nevertheless, the commercial office market remains challenging. Without large tenant precommitments few large projects are likely to commence.

Residential reboot

With many parts of Australia experiencing acute housing shortages, the Albanese Government has promised to invest $10 billion in a housing future fund for social and affordable homes. It is anticipated 30,000 social and affordable homes will be built in the first five years of the fund.

Meanwhile, in late January the Chinese Government announced that it would no longer recognise foreign degrees and diplomas obtained through distance learning. This lead to a scramble as 40,000 students considered their options before the academic year commenced.

In the short term, the influx of international students will fuel the national rental crisis. The Australian Financial Review has predicted the Chinese Government's announcement would trigger an instant 5% rent rise in inner-city markets. But with the national vacancy rate hitting a new record low of 0.8% in January, according to Domain data, other voices worry the students will have nowhere to go. In this context, build-to-rent remains a growth area.

In the longer-term, the student accommodation sector will need to step up. The Student Accommodation Council says many Australian cities were already at capacity for purpose-built student accommodation beds before the Chinese Government's announcement. Brisbane, Perth and Adelaide are expecting zero vacancy rates in 2023.

Net zero and sustainability

The federal government's 43% emissions reduction target by 2030 continues to drive market transformation, as net zero commitments turn from promises to practical application.

Environment, social and governance is now a central consideration for investors and asset owners, placing pressure on project teams to deliver sustainable designs and driving adoption of smart technology to measure results.

The Green Building Council of Australia's recent updates to Green Star have delivered a quantum shift. Achieving a 6 Star Green Star rating has become far more challenging, and therefore more costly.

Measuring upfront carbon – the emissions generated during construction – is another potentially costly challenge. Contractors are now being asked to meet upfront carbon reduction targets and aren't always confident in how they will achieve that.

> "Contractors are now being asked to meet upfront carbon reduction targets and aren't always confident in how they will achieve that."

Image:
Bendigo Law Courts,
Wardle (Tim Griffith)

Completed 2023

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State by state trends

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

New South Wales

Our forecast escalation range for 2023 is 4-6%, but we estimate 3-5% in non-unionised sectors. Key factors include:

- **State election:** The people of NSW will head to the polls on 25 March. The caretaker period is now underway and significant decisions about large buildings and infrastructure projects have been put on hold until the outcome of the election is known.
- **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 in the trades continue to plague the industry, and federal government policy to encourage migration, notably the increase in the permanent migration program, is welcome.
- **Floods:** We continue to see high pricing and labour shortages in the state's north. Across trades, we have seen a jump of 15-20% in quoted prices over the last year. Assuming no new external contributing factors, the market should start to slow down and become more competitive in the medium term. While prices may not necessarily fall, they should become more certain for budgeting purposes.
- **Materials:** While steel and reinforcement prices have dropped slightly, costs for pre-cast concrete are rising as the small pool of suppliers scrambles to keep up with the high level of demand from infrastructure projects. Many supply chain issues that arose with Covid-19 have generally been resolved. The costs of shipping containers, for instance, has come back and international goods and materials such as façades, glazing and joinery are more readily available.
- **Regions:** The NSW Department of Health has a long list of regional projects on the go which are impacting the pricing of regional work.

Victoria

After two years of unpredictability, Victoria's market is on the move. Contractors are busy and we expect an underlying cost escalation of 4-6%, falling to the traditional average of 3-4% in 2024. Key factors in the Victorian market include:

- **Promises become projects:** The Andrews Government was returned in November, promising to continue to deliver on the infrastructure investment laid out in the 2022-23 Budget – expenditure that Infrastructure Partnerships Australia notes, amounts to $1.8 billion per month over the next four years. Health and rail projects promised during the 2022 election campaign must now be turned into projects. Victoria's May budget will be an important milestone.
- **Social housing:** The Victorian Government has announced a $5.4 billion "Big Housing Build" with the ambition to create more than 12,000 homes in four years. Of these, 9,300 will be social housing. The rest will be affordable or market-rate housing.
- **Credit crunch:** In May 2022, ratings agency Moody's downgraded Victoria's credit rating from AA1 to AA2, after stripping it of its AAA status in 2021. But the ratings agency also upgraded Victoria's outlook to "stable" after its 2021 "negative" assessment. To reclaim its AAA credit rating, the Victorian Government must pay down its considerable debt. Doing so may curb infrastructure spending. While some projects, like those for the Commonwealth Games and social housing, are mission critical others may be put on the backburner.

We are hearing from some contractors that they are busy, tendering what they know up until Easter, and then they have some capacity to look at new projects after that – a good sign for costs.

Image:
Capella Sydney,
Make Architects
(Timothy Kaye)

Completed 2022

Queensland

Costs have risen by around 1% each month for the last six months, driven mostly by an extremely tight labour market. Costs increased by 7-8% over the second half of 2022, and we expect escalation to run at approximately 6% over the course of 2023.

- **Demand and supply dynamics:** Brisbane's market and Queensland's regions are equally constrained with demand for skills far outstripping supply. As a consequence, many developers are unable to attract a single tender for large, lucrative jobs.
- **Skills squeeze:** Queensland's skills shortage is acute, with Infrastructure Australia's Public Infrastructure Workforce Supply Dashboard revealing a current shortfall of 16,400 skilled required to deliver on publicly-known Queensland projects. Many programs are at risk. The Queensland Government committed to build 5,600 public housing dwellings over five years, but last year managed to deliver just 130 - a fraction of its target.
- **Residential reframe:** Many new Queensland homes are now taking a year to build – double the pre-pandemic timeframe. Many large private multi-residential projects have stalled; Scott Hutchinson, chairman of Australia's largest privately-owned construction company, publicly commented in February that "we want more projects to stall so the industry can get back on its feet".
- **Wet weather:** Brisbane lost around 40% of its construction days, with sites soddened by the wettest year on record in 2022. Builders are still playing catch up from the months of delays.
- **Rethinking contracting models:** Builders in Queensland have been hard hit over the last year and many are carrying losses that are not sustainable. Design & Construct contracts are increasingly unpalatable, and even large projects are being turned down by builders who perceive an unequal risk and reward equation. Other builders are bringing services inhouse to better manage risk.

The 2032 Olympic Games are the biggest opportunity on the horizon, as projects needed to host the world's largest sporting event in 2032 begin to take shape. Most of these projects, like the $2.7 billion redevelopment of the Gabba, will take five years to unfold. However, regional councils are using the Olympics as an opportunity to dust off plans for sporting facilities.

Preliminary design and budgeting over the next two years will translate into shovels into the ground following that.

Image:
IAG Adelaide, Cox Architecture (Tim Griffith)

Completed 2022

South Australia

While there are some indications that the pipeline of work is narrowing and consultants are beginning to look for work, we continue to forecast a 5% escalation over the next 12 months. Key local market influences include:

- **Government projects:** The South Australian Government's Department for Infrastructure and Transport maintains a steady pipeline of projects, especially in the health sector. Among those in planning or concept phase are a new $120 million headquarters for the state emergency services, $88 million for the South Australian Sports Institute redevelopment, multiple technical colleges, $80 million for the Adelaide Aquatic Centre and $3 billion for the Women's and Children's Hospital. The location for the new $220 million Mount Barker Hospital has also been confirmed. As these projects move into construction, they will soak up skills and exacerbate labour shortages.
- **Private sector projects:** Adelaide Economic Development Agency is keeping tabs on long list of city shaping projects. This includes several ambitious private sector projects, like the $1.25 billion mixed-use development proposed by Melbourne-based Gurner and Kennards Self Storage at the former Australia Post site; commencement of the $450 million Central Market Arcade Redevelopment; Charter Hall's $450 million office development at 60 King William Street, and a $450 million health and medical research hub on North Terrace led by local firms 1835 Capital and Marlborough Capital.
- **Demand for trades:** We expect skills shortages to peak over the course of this year. The market continues to report strong demand across most trades and materials, notably civil, carpentry, plasterboard, joinery, roofing and cladding. Standard pre-cast and steel has come back from its peak in 2022.

The Department of Infrastructure and Transport continues to incorporate contract clauses that recognise the need to share risk between client and contractors.

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Tasmania

Supply and demand factors dominate cost escalation assessments in Tasmania – and this will continue for the next 18 months. Although the residential sector is showing signs of slowing, the commercial and infrastructure sectors continue to experience sustained demand.

We estimate escalation over the next six-to-12 months to correct slightly, falling to 10%, down from an average of 12% in the previous period. Looking further ahead, we expect conditions to soften to 8% as pressure on material supply eases.

- **Labour shortages**: A slew of publicly funded projects is driving demand for labour, but the state has a constrained pool from which to draw. Securing interstate talent on short-term contracts can attract a wage premium upwards of 35%.
- **Subcontractor struggles:** The pool of Tasmanian subcontractors is small and head contractors are all competing for the same skills. Several trades have taken an opportunistic approach to the current shortages and that is reflected in pricing. Similarly, local workers are well aware of supply and demand imbalance and are job hopping. For this reason, we provide a 5% specific "Tassie market-related factor".
- **Program delays:** Pressure points in several key trades, notably plastering, mechanical and electrical, continue to cause program delays. We are warning clients that existing projects will take longer to finish and feasibilities on some new projects will drag out until the market corrects.

In the long-term, Tasmania needs to develop tangible strategies to attract and nurture a local talent pipeline, combined with incentives that encourage businesses to source interstate skills.

Western Australia

Cost escalation is holding steady at 7-8% as people now accept this as the 'new normal'. While we are optimistic that it will fall to a more manageable 3% over time, we expect this will only occur after interest rate hikes and inflation have settled.

Cost escalation in Western Australia tends to be more turbulent than other states because it is tied to the resources sector. The state's construction market therefore bears some unique characteristics:

- **Mining skills magnet:** Record resources output last year fed local inflation, diverting human and material resources away from non-resources construction projects.
- **Government spending:** The Western Australian Government is spending around $10 billion on public infrastructure projects in 2023 that will absorb a large proportion of the state's labour pool. The WA Government appears to have accepted that mass migration from the East Coast is unlikely to be a solution and is looking to roll out an equitable infrastructure pipeline accompanied by a renewed drive for overseas talent.
- **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 few or no tenders offered.
- **Material shortages:** Project teams have become accustomed to longer lead times on materials and are embracing early procurement and design. Where lead times were once six weeks, six months is now accepted for specialist materials. Clients, appreciating this, are more accepting of earlier 'deposit' payments (with usual security).

Unresolved resourcing issues continue to influence the appetite of larger clients, and those not already active in WA, to invest in projects. It will take a period of stability for investments to materialise.

We are now starting to see more large contractors and some services (mechanical in particular) projecting both availability and appetite for taking on new work. This is a good sign that some capacity will return to the market. While prices won't return to 2019 levels, we are now seeing much more alignment between expectations and contractor realities.

Much of the current conversation is focused on 'risk sharing'. There is a growing acceptance that the current allocation of risk between parties is a significant contributor to project and contractor failure. However, this discussion is yet to move beyond high-level principles or to focus on risk reduction in the first place.

"Much of the current conversation is focused on 'risk sharing'. There is a growing acceptance that the current allocation of risk between parties is a significant contributor to project and contractor failure"

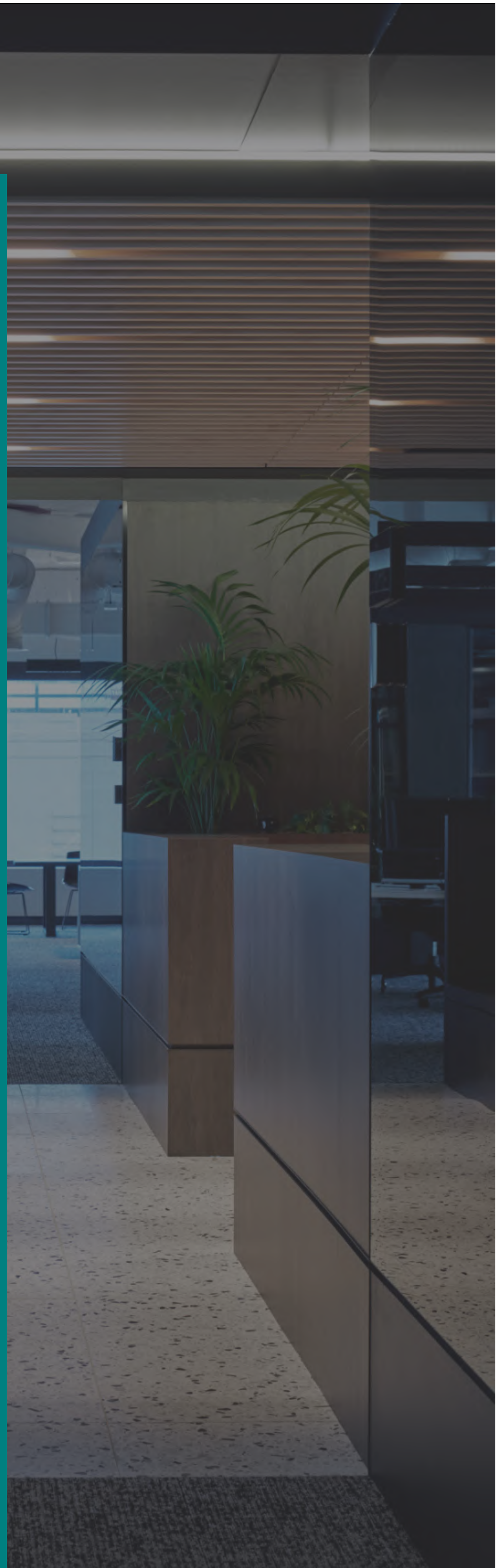

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Image:

Rosina Gunjarrwanga
Wak and Kun-madj (dilly bag), 2019 (left), and Wak Wak, 2019 (centre)

Kenan Namunjdja
Djulng, 2020 (right)

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

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