Slattery National Market Update

Risk averse, but resilient

August 2023

Risk averse, but resilient

Inflation, interest rate hikes, a high rate of construction insolvencies and a consumer sentiment slump may be clear signs of a slowdown. But employment markets remain tight, projects continue at pace and the ever-resilient industry is looking to new opportunities.

Overview

In this update, Slattery examines how Australia's construction market is responding to both macroeconomic forces and market-specific issues.

We cover primary cost pressures and provide a state-by-state commentary on the factors influencing costs.

Image:
Wyndham Law Courts
Court Services Victoria
(click the image to watch this project come to life)

The forecast

Slattery is forecasting an average of 4%-6% per annum for the remainder of 2023 in Australia's major markets, although 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% per annum in 2024. However, cost predictions can be precarious, especially in globalised markets.

Therefore, we recommend clients analyse their portfolio of projects to understand the impact of cost escalation and adopt appropriate mitigation strategies .

City	2022 (actual)	2023	2024 and beyond
Sydney	6-8%	4-6%	3-5%
Melbourne	8-10%	4-6%	3-4%
Brisbane	10-12%	6%	3-5%
Perth	10-12%	2-3%	5%
Adelaide	5-7%	4.5%	4%
Hobart	10-12%	8%	6-8%

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National overview

Cost-of-living pressures, interest rate rises and global geopolitical uncertainty continue to erode consumer confidence, which sits at what the Westpac-Melbourne Institute Consumer Sentiment calls "near recession lows".

Inflation has passed its peak, but at 7% per annum is still well above the Reserve Bank's target of 2-3%. With Australia's cash rate now at 4.1% – an 11-year high – developers are becoming increasingly nervous about funding and the feasibility of their projects.

According to the June 2023 ANZ/Property Council Survey, finance and interest rate expectations are now in negative territory, while pricing pressures continue to hurt industry confidence.

Insolvencies

Insolvencies remain an industry-wide issue, as construction companies continue to deal with the impact of multi-year contracts signed well before costs escalated. Construction topped the table of insolvency statistics from the Australian Securities & Investments Commission (ASIC) over the last financial year. A massive 2,117 construction companies went under in 2022-23, according to ASIC, compared with 1,207 the previous year. The next industry was accommodation and food services, with 1,058 insolvencies. In this economic climate, subcontractors are less willing to take on risk, especially on complex projects. Pricing on high-risk profiles are, therefore, exceeding expectations.

Materials

The growth in materials costs has eased over the past six months, as shelved or delayed projects reduce demand for some materials. But this easing follows record rates of cost escalation in 2022. Infrastructure Australia's 2022 Infrastructure Market Capacity report, noted that the cost of some construction materials had risen by an average 24% in just 12 months.

Prices for some materials, notably steel, have plateaued. Price increases are now more closely aligned with the volume of work in the market. We are seeing healthy interest from a wide range of trades during the tender process, and some competitive pricing.

Looking ahead, the market appears to accept cost escalation as inevitable. Nearly half (48%) of respondents to the June 2023 ANZ/Property Council Survey expected construction materials to rise by at least 5% over the next year.

Skills

Nationally, the unemployment rate of 3.6% remains close to a 50-year low and labour force participation is at a record high. Conditions in the labour market have eased slightly, with the Australian Bureau of Statistics noting a 2% decrease in vacancies in its latest data, although there were still 33,000 vacancies for construction positions nationwide and skills remain tight for many key trades. Skills supply won't match demand until March 2025, according to Infrastructure Australia estimates.

Meanwhile Consult Australia's latest skills survey of 21,000 engineers, design and advisory consultants notes that 60% of respondents are experiencing capacity constraints as a result of skills shortages, but most expect to have capacity within the next six to 12 months.

Against a backdrop of inflation and rising labour costs, current enterprise bargaining agreements are expiring and will be negotiated. The Construction, Forestry, Maritime, Mining and Energy Union (CFMEU) has signalled its intent to negotiate for an 8% increase to wages. We are starting to see subcontractors price in these predicted wage rises on projects that may not break ground for several years.

With labour at a premium for both trades and professional services, we expect these costs to remain well above expectations for the remainder of 2023.

Infrastructure

The Australian Government announced a snap strategic review of infrastructure projects in the May 2023 Federal Budget. This foreshadows major cuts to the $120 billion infrastructure pipeline and is creating some uncertainty in the market.

Meanwhile, the federal government's 43% emissions reduction target by 2030 is a hard deadline that continues to drive market transformation. The end-of-decade goal includes an 82% use of renewable energy across the power system – an enormous task that Energy and Climate Change Minister Chris Bowen has said will require the installation of 22,000 500-watt solar panels every day for eight years along with 40 7MW turbines every month, all backed by at least 10,000-kilometres of additional transmission lines. This large-scale investment is absorbing resources and skills that may otherwise be directed to other projects.

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Key national impacts *cont.*

Residential

With the Australian Government's $10 billion Housing Future Fund still stalled in the Senate, housing affordability continues to be a barbecue stopper. Rising interest rates are hurting the hip pockets of the third of Australians who hold a mortgage, and developers are finding it harder to get projects to stack up as interest rates rise.

Rental vacancies continue to stand at 1% in most markets, and governments are looking to incentivise build-to-rent development with tax concessions. BTR could deliver 150,000 homes over the next decade but most developments won't be delivered for several years, and many will be at the premium, rather than the affordable end, of the market.

Commercial

Average vacancies in Australia's CBD sit at 12.5%, according to the latest Property Council Office Market Report. Without large tenant precommitments few large projects are likely to commence.

Large institutional investors and real estate investment trusts (REITs) are more cautious about where they deploy capital and this is translating into fewer new projects. Nevertheless, global capital sees Australia – with its stable governments, mature market and highly-skilled workforce – as a safe place to park money.

As commercial tenants in CBD markets continue their flight to quality, asset owners are reassessing the highest and best use of existing assets. Several large developers are looking to retrofit to secure higher rents, while others are reimagining their assets as residential. Local moves come as city governments in other markets step up and adopt a 'retrofit first' policy. As the industry sharpens its focus on embodied carbon – the emissions generated during construction – more value will be placed on repurposing and retrofitting.

Sustainability

Sustainability is a massive focus for asset owners, managers and investors, and ESG – environment, social and governance – is a conversation topic around the country.

Many developers see sustainability as a differentiator today; but it will rapidly become a "ticket to play" as investors increasingly ask developers, consultants and builders to demonstrate their credentials. As the finance industry looks for 'green flags', the Australian Government has backed development of a sustainable finance taxonomy, with funds allocated in its May Budget.

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

Measuring upfront carbon is another potentially costly challenge. NABERS is currently collaborating with the industry on a framework to measure embodied carbon, with the promise of a tool to be released in 2024.

Increasingly, we are seeing institutional investors incorporate quantity surveying and carbon into the one RFQ. As ambitious project teams push the boundaries on low-carbon materials, supply chains are adapting and manufacturers are rapidly innovating. We expect a minimal cost premium on low-carbon materials in the not-too-distant future.

Rethinking contracting models

The conversation about appropriate 'risk sharing' continues. Builders over the country have been hard hit by the 'profitless boom' and many are carrying heavy losses. Design & Construct contracts are increasingly unpalatable, and there is a growing acceptance that the current allocation of risk between parties is a significant contributor to project and contractor failure.

We are seeing fewer builders prepared to sign up for fixed price contracts because of the risk profile. Some builders are bringing services in-house to better manage risk, while others are insisting on Early Contractor Involvement.

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State by state trends

Australia's construction costs are influenced by local constraints and challenges. Our round-of-the-grounds covers some of the key costs in each market where Slattery and its partners operate.

New South Wales

The Minns Government will release its first budget in September. As the market waits for pipeline visibility, our forecast escalation range for the remainder of 2023 is 4-6% per annum. Key factors include:

- **Shrinking infrastructure pipeline:** Following the Labor Party's victory at the April election, new NSW Premier Chris Minns has foreshadowed significant cuts to infrastructure spending as the state's debt soars to $187 billion. Contractors are telling us they have pipeline visibility for the next six months only. In the meantime, large infrastructure projects continue at pace, although some 'nice to have' projects – especially smaller, discreet projects like road upgrades – are now under review.
- **Prices rise for high-risk jobs:** The local market is somewhat spooked by the rate of insolvencies and the response to high-risk tenders has been quite poor. Trades are pricing risk accordingly and this has translated into significant cost increases of around 8% for these jobs in just six months.
- **Private sector projects on hold:** Some new commercial office tower projects have stalled as large tenants rethink their office footprints. Real estate investment trusts are pulling back on their capital investments and others are looking at asset repositioning. We are seeing a clear pivot towards adaptive reuse in the Sydney market, with upgrade projects adding value to lower grade stock while addressing the growing embodied carbon issue.
- **A tight labour market:** Shortages in the structural trades, notably reinforcement, are still an issue and this is reflected in pricing. In general labour is more of a concern than materials, with the NSW-wide unemployment rate now sitting at record low of 3%.
- **Residential reboot:** NSW annual building approvals – an indicator of future activity – have been subsiding since the end of Homebuilder-driven impacts and are below their decade average levels. Attached and multi-units currently make up around 50% of all approvals. With a projected housing construction shortfall of 134,000 dwellings over five years, the Minns Government has announced incentives for developers that include at least 15% affordable housing in their plans.
- **Quest for quality:** NSW Building Commissioner David Chandler AO's quest for quality is now on everyone's radar in the state, and this is influencing the processes and procedures in companies that straddle multiple states.

Victoria

After the rampant escalation in 2022, there is less volatility in the tender market across all tiers. For the first time since 2021, head contractors are reporting good tender coverage across the major sub-contractors.

We expect an underlying cost escalation of 4-6% per annum for the remainder of 2023. This is looking likely to fall to the traditional average of 3-4% per annum in 2024. Key local factors influencing the Victorian market include:

- **Spending snipped:** The May 2023 Victorian State Budget was not an austerity budget; neither was it generous in terms of infrastructure investment. The Melbourne Airport Link, for instance, is on the backburner and the budget does not list a completion date for the Western Rail Plan. Thirty-two major projects in the Victorian Government's budget are on pause as part of the federal infrastructure review.
- **Delays hit hard:** Victoria's infrastructure agenda is taking 21% longer to build than the Andrews Government expected just a year ago. This has bitten into the government's bottom line by $565 million.
- **$3.9 billion interest bill:** Rising interest costs to the tune of $400 million tore a hole in the state budget. The interest bill on government debt reached $3.9 billion for the last financial year, equivalent to about 4.7% of total revenue. Treasury modelling has found the state will shell out $7.4 billion in 2025-26.
- **Games creates a welcome gap:** The Andrews Government's decision to cancel the 2026 Commonwealth Games means any regional projects will likely be slower to come to market. This may add to the increase in capacity.
- **Insolvencies a worry:** Insolvencies in Victoria continue to be a concern. Following the high-profile collapse of home builder Porter Davis, two of the state's largest plumbing businesses have folded. In response, the State Government has promised to extend land tax exemptions for property owners when their builder goes under.

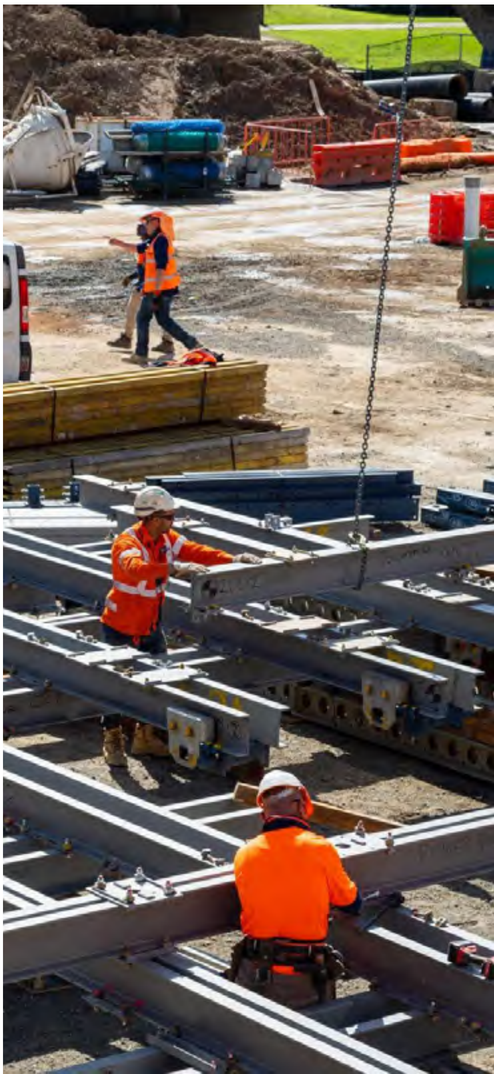

Image:
Powerhouse Parramatta
Images for Business
Infrastructure NSW
(click the image to watch this project come to life)

Queensland

Schools, hospitals, Olympics stadiums, roads and rail... Queensland has a long list of projects on the go and none of them will wait. Consequently, costs continue to rise by 0.5% per month in Brisbane, and up to 0.9% each month on the Gold Coast. Given the state's extremely tight labour market, we expect escalation to run at an average of 6% per annum for the remainder of 2023. Key local factors include:

- **Olympics bonanza:** The state government has committed almost $60 billion to projects in preparation for the 2032 Brisbane Olympics, including housing and roads infrastructure. This is in addition to the $7 billion dollars allocated by the federal and state governments for six new venues, eight upgraded facilities and 23 existing ones. Most of these projects, like the $2.7 billion redevelopment of the Gabba, will not break ground until 2025.
- **Skills squeeze:** A shortfall of tens of thousands of skilled tradespeople and professionals continues to blow out project timelines and budgets. CEO of Queensland's top builder, Hutchinson's Builders, recently warned that the ambitious Olympic Games program is at risk. While the state desperately needs trades and professionals – notably mechanical, electrical and hydraulics specialists – to deliver the infrastructure for the growing state, their arrival exacerbates an already acute housing shortage.
- **Public sector pipeline:** Queensland's major projects include the $6.9 billion Cross River Rail, other multi-billion-dollar road and rail projects, plus $578 in expenditure on schools and $861 on the Southern Queensland Correctional Precinct.
- **Hospitals on the horizon:** Queensland Health has three new hospitals and nine major hospital expansions totalling more than $8 billion worth of capital works. By mid-2024 we can expect to see many boots on the ground, with projects scheduled for delivery from the second half of 2026.
- **Risky business:** It is increasingly difficult to attract subcontractors to projects above the $50 million mark that they perceive to be risky. Many contractors are simply uninterested in bidding for private work while their books are full. Others, driven by fear of market insolvencies and rising wages bills, are incorporating a substantial buffer on tenders.

South Australia

We have revised our cost escalation forecast to 4.5% per annum for the remainder of 2023, down from the 5% predicted at the beginning of the year. We expect escalation to fall back to 4% in 2024. Interest rates are having some impact in the South Australian market, and some private development projects are on hold; however the local market remains robust. Key influences include:

- **Government projects:** The South Australian Government's Department for Infrastructure and Transport (DIT) maintains a strong pipeline of projects, especially in the health sector. Among those in planning or concept phase are $120 million headquarters for the state emergency services, $220 million for the new Mt Barker Hospital, $88 million for the South Australian Sports Institute redevelopment, $135 million for the Adelaide Aquatic Centre and $3.2 billion for the Adelaide Women's and Children's Hospital. These projects will aggravate continuing labour shortages.
- **Private sector projects:** Adelaide Economic Development Agency is tracking a long list of investments, including the $400 million Market Square Development, which commenced construction in June, and the $200 million Festival Tower which is due for completion in December 2023. This is alongside multi-million investments in the Lot Fourteen and BioMed City innovation districts.
- **Skills and materials:** Sourcing the right skills continues to be a significant issue, with strong demand across most trades and materials, notably civil, architectural precast, carpentry, plasterboard, joinery, roofing and cladding. While trades are being selective with anything with a degree of difficulty, we are seeing general enthusiasm from trades to tender.
- **Rise and fall provisions:** From 15 May 2023, the State Government will no longer include rise and fall provisions in commercial building contracts. These provisions had been implemented in all commercial building contracts managed by DIT's Building Projects Directorate from 1 August 2022. Removing rise and fall contingencies reflects a stable market outlook; trades are now factoring this into their tenders.
- **Refurb and retrofit:** The office flight to quality is driving developers to upgrade existing assets, and we are seeing significant projects take shape, such as Keystone Tower, a $400 million project on North Terrace to reimagine Freemasons Hall, and Quintessential Equity's $30 million upgrade of 30 Pirie Street.

Tasmania

While we expect some belt-tightening over the next 12-to-24 months, the Tasmanian construction market remains buoyant, with large-value projects underway or in the pipeline and government infrastructure programs continuing at pace. We estimate escalation over the next six-to-12 months to sit at 8% per annum, down from 10% in 2022. Influences of note include:

- **Resilient economy:** Australian Bureau of Statistics building approvals data shows Tasmania's construction sector continues to outperform the nation, with the value of building approvals in the state rising to $2.4 billion, an annual increase of 17.7%. Tasmanian Treasurer Michael Ferguson has noted Tasmania's economic recovery occurred sooner than other states, and the state is now in a period of "normalisation" following "exceptionally high growth".

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- **Large-scale projects:** As a significant volume of new large-scale projects come to market, the balance has shifted from tertiary education projects to those in defence and healthcare. The Tasmanian Government will spend more than $1 billion on critical health infrastructure, for instance. In the private sector, several highly-anticipated hotels are in the pipeline, including a 180-key hotel in The Hanging Garden.
- **Labour shortages:** The 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%. The biggest pressure points remain plastering, mechanical and electrical trades.
- **Residential cools:** Interest rate rises have cooled activity in the residential sector, and attention is now focused on commercial projects. We are seeing more competitively priced tenders, subcontractors showing more interest in projects and, in general, a greater trade coverage, especially in the sub-$50 million category.
- **Stadium a slow burn:** The proposed 23,000-seat stadium at Macquarie Point is several years away, and is yet to attract approval among large sections of the community. The estimated $750 million price tag is both controversial and optimistic. The first phase, which includes a $60 million high-performance training centre, will have an impact on in-demand skills.
- **Interstate interest:** Tasmania's strong economy continues to attract interstate interest from developers, but they are struggling to make their business cases stack up because of prices. Businesses with in-demand skills are also looking to establish a Tasmanian footprint, and may address current bottlenecks if they can make strong connections in local networks.

Western Australia

The local market has stabilised and is maintaining a period of relative predictability. We expect costs to hold at 2-3% per annum for the rest of this calendar year, and to sit at around 5% for 2024. Some of local factors influencing the WA market currently include:

- **Waning appetites:** Materials shortages are no longer the industry's biggest delivery challenge. Instead, we are seeing little appetite within the market to bid for work outside relatively lower value public sector projects. Anything above $50 million – and especially private client projects – is becoming very difficult to secure delivery partners. The multi-unit residential market is of particular concern, given the centrality of the sector to liveability, affordability, and the state's ability to attract skills from the East Coast.
- **Mining skills magnet:** Demand for mining skills is in lockstep with commodity prices, and the mining industry continues to divert human and material resources away from non-resources construction projects. Western Australia's economy tends to be countercyclical, but with all state and international economies firing, WA has been unable to attract additional skills from other markets. This has also led to a reduction in levels of apprentices in construction-related trades, which will further exacerbate the problem in the future.
- **Migration matters:** 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. In April 2023, the state government announced a new Construction Migration Office to help Western Australian businesses looking to hire skilled migrants.
- **A 150-kilometre challenge:** Stretching 150km along the coast from Two Rocks in the north to Mandurah in the south, the Perth-Peel metropolitan area is considered the longest city in the world. While Perth has a 47% urban infill target, the suburbs sprawling north and south of the CBD have accommodated most of the city's burgeoning population. This continues to present infrastructure delivery challenges, as well as liveability issues. Recent government incentives, including headworks fee relief and a focus on inner-city affordable housing, are welcome but may have little impact without improved delivery appetite.
- **Longer lead times:** Project teams are now 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, understanding this, are more accepting of earlier 'deposit' payments (with usual security).

Overall, the feeling in WA is one of "frustrated confidence". There is a real desire to deliver, but frustration in not having the capacity to do so.

> "While economic indicators suggest a bumpy ride, Australia's construction industry remains resilient. Projects are progressing and new avenues of opportunity – whether that's world-class infrastructure, revolutionary retrofits or low-carbon construction – are ahead."
>
> **Sarah Slattery**
> CEO, Slattery

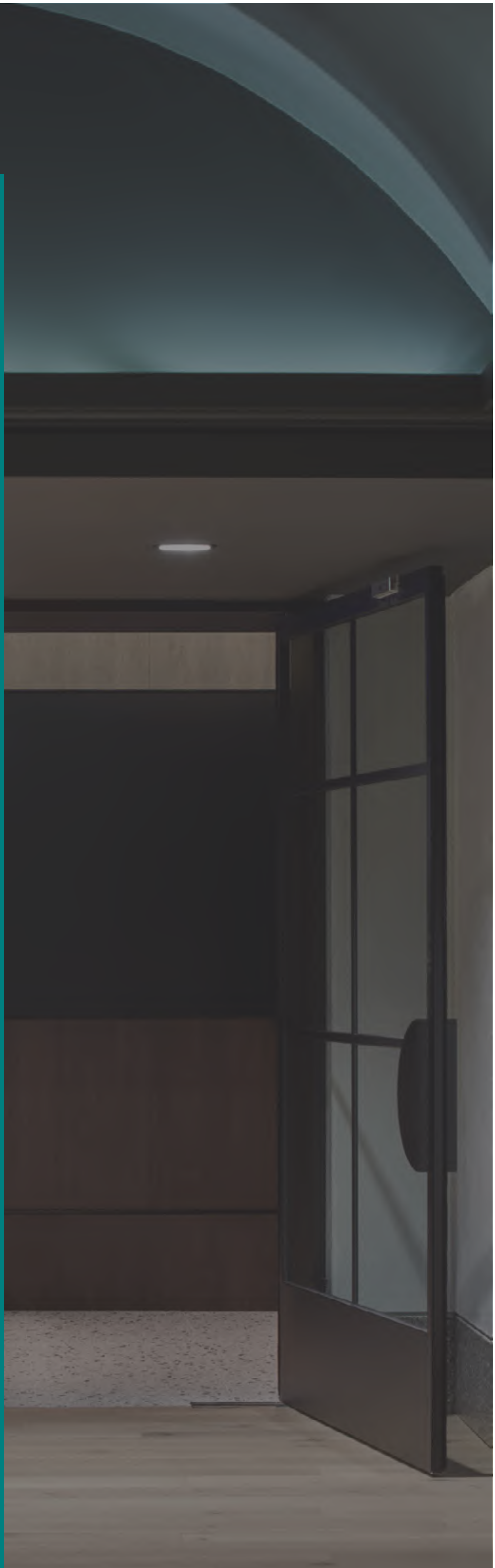

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Image:

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

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.

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