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NEW ZEALAND CONSTRUCTION MARKET & ESCALATION FORECAST

RLB Rider Levett Bucknall

NZ CONSTRUCTION MARKET & ESCALATION FORECAST APRIL 2020 UPDATE

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Clients have always asked us: where is the NZ construction market going and where are prices heading? We have always answered this, and for 24 years RLB has produced our Quarterly New Zealand Trends in Property and Construction Forecast Reports. With construction commencing again next Tuesday, the question is being asked louder than ever, and the answer is a lot less straightforward than at any other time. There will be inflationary factors, market forces and constraints that have a significant influence on costs in the near future in New Zealand.

Only 7 weeks ago we issued our RLB Forecast 94 report for Q1 2020. The commentary noted solid construction activity nationally, with an increasing pipeline of new consents against a backdrop of some global economic headwinds. The NZ Construction market and our Non-Residential Building Index (CGPI-NRB Index) has experienced some significant increases between the 2015 and 2019 period (a total rise of 25%) and our escalation forecast in this last report was almost a “return to normal” at a steady 2.7% during 2020 and 2.9% in 2021.

Events have moved on at pace since this report and the economic impacts of the health crisis will continue to play out over the next weeks and months and the escalation forecast will continue to evolve. Post the last recession in 2008 after the GFC, our Non-Residential Building Index (CGPI-NRB Index) fell 3.8% during 2009 and then remained flat for the next three years, with only a 1.5% increase between 2010 and 2012 before the recovery and boom phase. With some projects going on hold or being cancelled, and the private sector now needing to hoard cash and defer forward capital works, there is a perception from some quarters that prices will fall in the near term because of shift to more supply than demand.

We feel before jumping towards an expectation of a general fall in costs and any de-escalation forecast, there are a number of factors and changing variables that need to be understood and considered. Particularly in the near term over the next 6 months and into 2021, we have sought to set out the case for both a potential de-escalation period or potential increase to costs.

THE NZ CONSTRUCTION MARKET

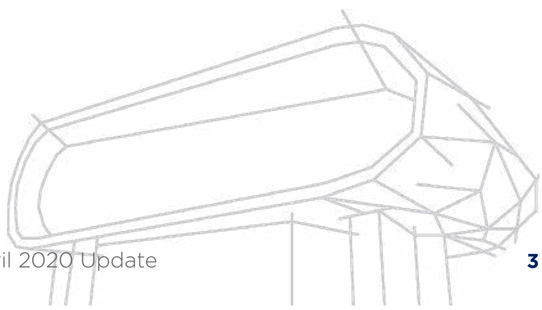
Consideration needs to be given to the size of our pre-COVID construction market and the composition of the work. Our construction market is a $39bn industry, comprising of circa $20bn Residential construction (nearly all privately funded), commercial and vertical construction of $10bn (largely privately funded but including Government-funded social infrastructure) and Horizontal infrastructure at circa $9bn (largely Government funded).

The Construction project financing composition can therefore be considered circa 20-25% government funded ($9bn to $10bn) and 75-80% private funded ($28bn to $30bn). The anticipated government boost of increased spending on horizontal infrastructure and vertical social infrastructure construction will certainly increase this proportion and will exceed $10bn annually over the next few years. However, the extent of the fall in the privately funded sectors in both the residential and non-residential remains uncertain. The government may underwrite some private “hammer ready” vertical projects with either national or regional benefits to offset some of the fall, but the extent of the support and for which major projects is not likely to be clear until later in May.

THE CASE FOR ESCALATION & PRICE FALLS

Factors to consider for upward pressure include:-

- Less demand and more supply. If the government spend-up is insufficient to make up for significant drop in the private commercial and residential sectors, then market forces will drive harder competitive pricing, particularly in the non-infrastructure space. Simple low-rise residential and industrial shed type projects will have far more capability in the market to deliver these, and likely downward price pressure will result.
- Forward work now going on hold or being cancelled will lead to an initial scramble and strong competition to fill order books that looked healthy just 6 weeks ago.
- Need for immediate cashflow in the short term as debts increase and businesses struggle to survive. Pricing projects below cost and a “race to the bottom” approach. Unsustainable in the medium term and will lead to failures.



THE CASE FOR ESCALATION & PRICE FALLS CONTD

- Unemployment levels will have a major factor in the cost of labour; significantly higher unemployment over the next 12 months will result in a more competitive the labour market, potentially in both the skilled and unskilled sectors. However, construction is already a low wage base industry, and more resource availability is unlikely to improve productivity, so this may not have a significant influence on costs.
- Recalibration of wages to a lower base in the skilled sector as we move from boom to a recession. Contractor and Sub-trade P&G and people cost overheads will likely reduce in the near term as the number of large projects reduces.
- More competitive price-driven procurement models in the private sector driven by budget constraints. Lowest price over the right price or non-price attributes in the selection process.
- Available Residential and Commercial sector trades moving across into social infrastructure and horizontal infrastructure work – a glut of available resource for the government spend.
- As forward work in the design/engineering/consulting space slows down, quality of documentation may improve with more available time to get it right. This reduces risk which can improve both tender pricing and the final price at completion.
- RMA process and consenting may get easier and faster with government red tape cutting and/or a relaxation of Resource Consent conditions, saving time and increasing productivity on site. However, Council debt levels and falling revenue may see a cutting of resource back in this area rather than improving performance and outputs.
- Falling consumer confidence. Residential construction is driven by market sentiment combined with the lending appetite of the banks. With both likely taking a hit, significant downward pressure through a lack of short-term demand in the Residential sector will influence price. This sector currently makes up half of the construction Industry.
- Strengthening NZ Dollar. Whilst currently weak and always subject to fluctuation, if New Zealand quickly moves down the Alert Levels and the economy kicks in much faster than overseas, then the NZ$ may strengthen sooner and the material buying power will increase on projects in the near term.
- General NZ CPI inflation is low combined with historically low interest rates. This gives general stability without upward pressure or strong influence on construction prices. Low commodity prices such as Oil currently may influence lower costs and deflation in CPI.

THE CASE FOR ESCALATION & PRICE INCREASES

Factors to consider for upward pressure include:-

- COVID-19 related H&S compliance in the near and medium term. The compliance cost of seismic engineering, passive fire and weathertightness has increased construction costs over recent years and increased H&S measures on site; shift working and changing work practices will have a similar impact on cost. Programme extending out due to productivity issues meaning increased P&G costs.
- Future COVID-19 delays and disruption that may come if a “Second Wave” or outbreak occurrs. Contractors are unlikely to take on any COVID-related risk in construction programmes and the supply chain. Clients will need bigger contingencies for this risk and projects have a higher exit price potential.
- If fixed price, fixed programme options become “COVID-excluded” then may not be worth a great deal in terms of risk transfer and it may lead to other procurement models such as Construction Management or Cost Reimbursement.
- The Construction Accord and Government procurement models on horizontal and vertical social infrastructure will likely see more Alliancing, Cost Plus or Open Book contracting. These approaches focus more on delivery drivers and time and quality but may come at a price premium.
- More open book cost reimbursable forms of contracting for time and quality gains will come with a likely trade-off of higher cost and higher margins and cost risk client-side. This is likely on fast track government work, and processes and monitoring will need to be strong to ensure price gouging does not become an issue.

THE CASE FOR ESCALATION & PRICE INCREASES - CONTD

- Falling NZ$ in a recession. Always subject to fluctuation but the dollar is currently weak although improving. The costs of materials to a large-scale standard project currently account for approximately 35 – 40% of the total cost in New Zealand. Big shifts in currency can have a strong influence. It should be noted the USD and the Euro typically make up a small portion of this material component. The Chinese Yuan typically has the greater influence on the material supply chain.
- Material cost increases (particularly overseas) directly attributable to COVID-19 impacts and inconsistent demand or outputs leading to shortages and price spikes.
- Interruptions to domestic and global supply chains due to COVID-19. This near-term issue may need alternative materials to be sourced at a potentially higher cost or the delayed materials air freighted to meet programme.
- Prefabrication options to de-risk the site construction time and contact. This may drive short term premiums but may become more efficient over time. Prefabrication needs consistent pipeline to succeed, though, and this has been notoriously fickle in NZ.
- Shrinking capacity. The construction capacity has already likely fallen during the lockdown and will likely continue. Skills will be lost and a sharp pick-up in demand particularly in the infrastructure sector may lead to increases in the medium term.
- Loss of temporary immigrant skilled workers likely as the workforce is shed. Current restrictions prohibit non-Residents coming in. Even when these restrictions are lifted, the 14-day quarantine process may continue much beyond. This will make overseas skilled workforce a premium. Paying for the 14 days whilst in quarantine as part of the project will add to cost.
- Less direct labour for Main Contractors and Sub-contractors as business reduce costs. More and more layers of subcontracted and self-employed labour on large projects, increasing the fragmentation of the NZ construction industry and further efficiency losses, which has continued to drive pricing up in recent years. This regression will reduce productivity, lead to further quality issues and increase tender pricing of this risk over time.
- A 'flight to quality'. Balance sheets and bonding capacity will be significantly eroded but clients will be seeking greater protection in uncertain terms. Limited Tier 1 Contracting options maybe available for the larger and more complex projects.
- A "Buy local" approach in NZ & Australia to de-risk short term global supply chain risk and boost the local economy may lead to short-term material price increases and shortages.
- Lack of industry investment, contributing to slow moves to prefabrication or manufacturing capability and investment in people and training.
- Extent of the sustainability and decarbonisation push particularly on Government projects may influence cost. Whilst it will deliver long term benefits, it may lead to initial capital cost price premiums, particularly in the near term.
- The complexity of Hospital and Infrastructure projects means they have greater risk, greater compliance, and lesser market capability which will likely increase tender pricing or exit costs over time.
- General reduction in industry investment and innovation in the near term is unlikely to see any efficiency improvement to help reduce costs.

SUMMARY

Whilst we may be heading into a recession with a reduction in construction demand, we don't anticipate this simply translating into a reduction in construction costs directly across the board. There are clearly a number of significant factors impacting on both escalation and costs to consider over the next 12 months. The amount of influence these factors have remains uncertain, and will continue to evolve over time.

In broad terms, in consideration of the factors above, we do expect escalation to fall in the near term in the residential and commercial sectors. **This maybe a decrease in the region of 4% to 6% in the next 12 months in residential and commercial. However, for horizontal infrastructure and for complex large vertical projects, we anticipate an increase in escalation is more likely of between 2% to 4%** because of the lack of large project capacity from Tier 1 contractors, the potential COVID-19 productivity and delivery risks in the near term, the increasingly fragmented sub-contract layers beneath them, and the less price-focused forms of Government procurement.

Given the Government-driven vertical and horizontal social infrastructure sectors may only make up 25% to 30% of the NZ Construction industry, and the amount of assistance to "hammer ready" vertical projects unclear, this may mean an overall average fall in pricing over the next 12 months. However, the complexity and delivery model of every project, together with the state of the local regional market, needs to be well understood before applying any escalation factor.

RIDER LEVETT BUCKNALL

An independent Cost Consultancy practice whose core services include Quantity Surveying and Cost Management services for the built environment. A team of 100+ dedicated and professional Quantity Surveyors and support staff working as one team across seven locations in New Zealand. A long history of successfully delivering diverse, complex projects. Founded in Auckland in 1957, we are leaders in our industry and are trusted and respected Cost Advisors.

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Director

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employees throughout New Zealand

60+

years in Auckland

60+ staff

in Auckland

33%

women employed

7 offices

across New Zealand