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Great Expectations?

AUSTRALIA MID-YEAR CONSTRUCTION MARKET VIEW

August 2020

Introduction

With multiple Government initiatives in place, the promise of economic recovery seems to be on the horizon. But how confident can we be that this promise will become a reality?

- The majority of the various levels of Government in recent months have been focused on managing the COVID-19 crisis and creating conditions to aid a speedy recovery. However, the extent of success will also depend on foreign relations, particularly with China, as well as the impact of a potential second wave of infection across Australia. The lack of agreement and verbal jousting that is now taking place between Australia and China will create new obstacles to a full economic recovery.
- The outset of COVID-19 caused widespread lockdowns across the majority of economies around the world. This has resulted in a number of significant interventions. The cost of the Australian JobKeeper payment scheme is estimated to be between $100 and $130 billion, with more than 1 million Australians having lost their jobs.
- A number of countries are now in the process of exiting lockdown and returning to a "new normal" albeit with all the challenges of driving economic recovery while keeping a potential second wave of COVID-19 at bay. The path to recovery will not be straightforward and is likely to be interrupted by recurrences of the virus, which will in turn drive risk aversion, lower business optimism and limit anticipated levels of activity.
- In Australia, the bulk of businesses and almost all services brought their operations to a halt for up to 10 weeks during the strict lockdowns that were imposed. While social distancing requirements have recently been reduced in some States to "1.5 metre plus", conditions are still challenging for many businesses. As a result, a complete opening of the economy is still not possible, and hence there is a limit to the speed of recovery.
- The latest Australia GDP data indicates a 10% contraction during the first half of 2020. Recent business sentiment surveys indicate a deep level of pessimism regarding economic conditions moving forward. However, the actual shape of the economic recovery is yet to be seen – and this is likely to differ significantly between States. 'V'-shaped, or the so-called 'Nike Swoosh', scenarios seem to be the most plausible, with the latter taking into account a slower recovery in consumption and investment. However, most economists are now of the opinion that a 'V'-shaped recovery is unlikely, unless a viable vaccine is discovered and distribution channels are seamless.

- The effectiveness of Federal and State Government prioritisation of infrastructure investment and focus on ‘shovel ready’ projects will go a long way to determining the shape of the recovery, but this will likely not be enough to keep the construction industry going – particularly for small businesses that typically do not get invited to tender for these opportunities.
- Most Australia construction sites were allowed to remain open during lockdown. However, several larger construction sites closed, at least temporarily, due to safety concerns and/or to adjust to new health and safety requirements. At the time of writing, almost all construction sites are continuing to operate. Furthermore, the Australian Construction Performance of Construction Index increased to 35.5 in June from 24.9 the previous month – according to the Australian Industry Group / Housing Industry Association. This signals that the pace of contraction has eased during this period, at least temporarily, and at least a partial return to business confidence.
- The lockdown period has inevitably led to a drop in construction output across many sectors and recovery to “pre-COVID-19” levels will take time. Even with a sharp recovery, 2019 levels of activity – which were already declining from 2017/18 – will not be achieved until 2021 at the earliest. Newly emerged risks relating to COVID-19 are casting a shadow on the new orders pipeline, with many clients revisiting their original business cases and postponing investment decisions.
- It is anticipated that more than $200 billion will be spent on stimulus packages during this crisis, of which JobKeeper Payments are a significant part. This equates to an estimated 3.3% of Australia’s GDP in the last financial year and 6.1% this year. Comparing this to the last economic crisis during the GFC, Australia was one of the few developed countries to avoid a recession, and stimulus spending was about 1.8% of the size of the Australian economy.
- Both Federal and State Governments see construction as a critical tool in their recovery planning. They are planning to use the industry to dig Australia’s way out of a recession and have subsequently launched an array of initiatives to speed-up development approvals and fast-track construction. Hundreds of projects are being given the green light in addition to exemptions being granted to reduce red-tape for major infrastructure projects.
- In the longer term, Government bodies will need to investigate ways to accelerate the procurement and delivery of major infrastructure projects, as well as simplifying the planning process.

The shape of the recovery

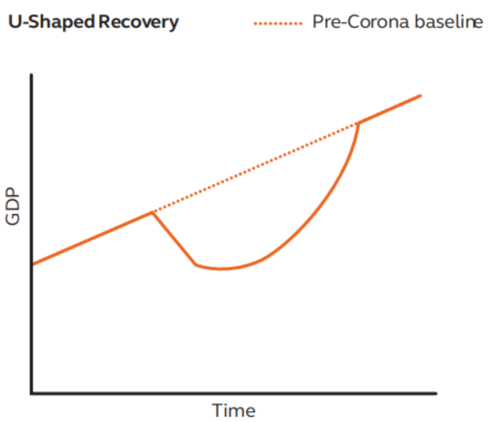
In recent weeks, we have seen a plethora of scenarios illustrated with various recovery "shapes". Economic commentators are trying to produce models that consider a variety of factors, including the probability of a second COVID-19 wave, the recovery in job markets, and the resurrection of consumer demand.

Recent surveys have indicated that not all clients are presently considering cancelling projects altogether, which is a good sign. But equally, concerns about viability and a willingness to delay spending decisions suggest that a rapid bounce bac is less likely.

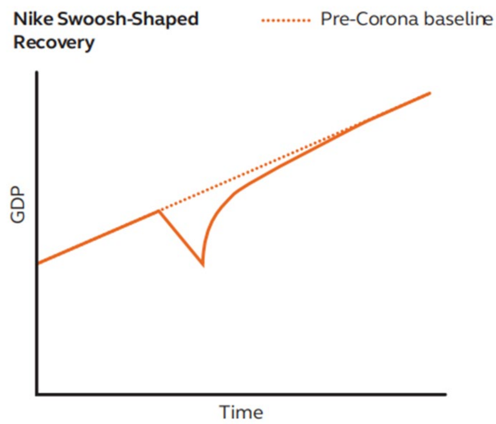
This leaves us with three potential recovery shapes outlined below, the likelihood of which depends on the timing of investment decisions, the readiness of the supply chain, and the successful implementation of lessons learned during the initial stages of disruption (safety procedures, contractual arrangements). The most optimistic scenario is the "Nike Swoosh". Regrettably, the more that investment gets postponed, the greater will be the odds for a U-shaped recovery in our sector.

Recovery shapes

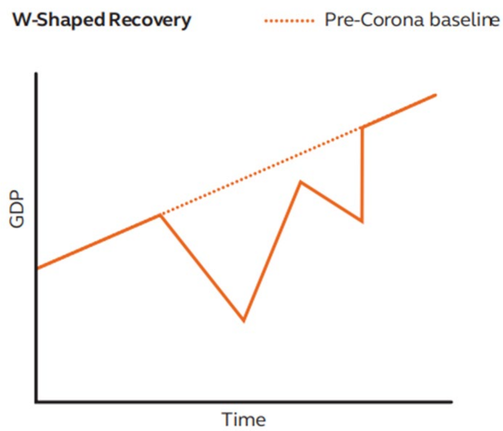
U-shaped – Clients tale more time reviewing projects and potentially decode to delay some of them. Some industry capacity could be at risk.



Nike 'Swoosh' – Clients decide to continue with their investments. Both public and private sector drive demand.



W-shaped – A double-dip may happen if the easing of lockdown restrictions initially boosts activity, but then effects of unemployment, business failure and public spending cuts combine with a second shock (i.e. higher risk of re-emergence of COVID-19.



Source: Hutchins Centre on Fiscal and Monetary Policy at Brookings.

Basis for the forecast

Despite encouraging signs in our post-COVID-19 recovery, risk of disruption remains an ever-present threat.

Post-pandemic forecasting must reflect a unique balance of supply, demand, and the influence of uncertainty. Clients and contractors who are looking to bring forward projects over the next year will be only too aware of new risks associated with health and safety, productivity, viability, local lockdown, and supply chain stability. Their increased sensitivity to risk is likely to be seen in higher hurdle rates on investment returns, more demanding contract terms and greater project selectivity.

The way these factors determine which projects proceed will have a big influence on the shape of the recovery and future market conditions.

Baseline – current state of the industry

It has become apparent that, from the outset of the pandemic, that the construction sector has been particularly vulnerable to the impacts of COVID-19. The sector has performed reasonably well in terms of keeping a large proportion of construction sites open and operational, but still the impact has been severe. A combination of reduced productivity, delayed project starts and completions, and increased fixed costs can be expected to sap the strength of the industry as the crisis goes on. This is a long-term problem for the sector.

The scale of the impact is highlighted by the potential size of the inactive workforce. Master Builders Australia have indicated that their members are reporting a 40% drop in contracts now and forecasting a further decline of 30% during this next financial year. If this void is not filled, then this could equate to approximately 400,000 jobs across the sector – and this does not include businesses that would be affected across the wider supply chain, such as architects, engineers, project managers etc.

The latest data indicates that, since mid-March, the number of jobs in Australia has decreased by 7.3% and wages have contracted by 5.4%. The situation is expected to worsen once JobKeeper expires in March 2021. Given the scale of this disruption, it is clear that the full effects on the health of the sector are yet to be fully understood.

Evidence of the pipeline is equally unclear. Orders for the first quarter were relatively strong, but new procurement activity has slowed considerably, with an Arcadis internal survey suggesting over 50% of sample clients have either cancelled or slowed active procurement as a result of the crisis. Despite the best efforts of the public sector to bring forward an infrastructure pipeline, it will not compensate for falling opportunities in the tertiary education, retail, commercial and residential sectors – creating a particular problem for specialist contractors that cannot easily transfer their skills from one sector to another.

Recovery scenarios

We have developed a series of recovery scenarios, which continue to be adjusted in line with changing market dynamics. In summary, the basis for our current forecast is as follows:

- We are less optimistic about Australia's ability to control future COVID-19 outbreaks, as we have witnessed in Victoria, and this could increase the risk of one-off site closures.
- Productivity has, generally, faired better than expected – although this is dependent on the sector and the stage of the project. Programs for existing and new projects are longer, and additional costs are being incurred to fast-track material supply, but individual task productivity is close to normal.

Optimistic case	Pessimistic case
• Smaller and isolated COVID-10 outbreaks recur during the latter half of 2020. • Social distancing reduces site productivity, resulting in longer program durations. • Progress on sites are disrupted periodically during 2020, reducing productivity further. • Contracts apply a flexible risk-sharing approach to COVID-19 disruption. • The price of construction work is determined in competition. • Investment-led public-sector recovery program procured during 2020 in anticipation of 2021 start.	• Large COVID-19 outbreaks recur during the latter half of 2020 across all States. • Significant on-site disruption results in widespread closures. • Productivity falls further due to multiple sources of disruption. • Contracts are not adapted to respond to COVID-19 disruption. • Industry capacity is lost as a result of widespread industry consolidation. • The price of work is undertaken on an open-book basis due to the extent of ‘unpriceable unknowns’. • Government cancels programs to generate savings.

As a result, we believe that the balance of inflation and deflation in the construction sector is starting to edge towards deflation.

A recovery in productivity and greater confidence in the availability of materials will help to reduce some of the inflationary pressures whereas a hiatus in forecast workload in the latter part of 2020 and the start of 2021 is already encouraging contractors to review the competitive position of their pricing.

At the moment, this has been focused on trimming resourcing levels and inflation allowances and, as a result, we have moderated our deflation projection for 2020 and 2021. Longer term, we retain a bullish view with respect to inflation, reflecting not only the size of the potential pipeline, but also the long term contraction of the Australia labour force.

Inflation forecast

Post-COVID-19 inflation factors

Inflationary	Deflationary
• Productivity constraints associated with social distancing • Fixed costs associated with longer programs and alternatively supply methodologies (i.e. air freight) • Weak currency • Loss of labour capacities • Access to insurance products and bonds	• Decreased workload as a result of reduced demand and confidence • Commodity prices • Reduced demand for labour and materials • Increased competition for available opportunities.

This is a significant turning point for the industry. Prices have been rising since 2014, but profitability across the sector has barely recovered. With further disruption anticipated, particularly with a second wave of the virus likely to occur across the country, we expect that contractors and their supply chain will take a risk averse approach to business development – focusing on quality work rather than work at any cost.

This represents an opportunity for clients who are ready and able to work with their project teams to bring forward de-risked and deliverable projects. We believe that it should also place a ceiling upon the level of deflation that can be absorbed by the supply chain.

If international migration does not start to occur by 2021, then we anticipate that Sydney and Melbourne could see a greater level of contraction than we are currently forecasting. Despite the harsher economic conditions, Perth is performing quite well and will be further supported by an improving world economy in 2021, which will translate into increased demand for iron. This would be a welcome change for Western Australia as a whole, which has languished in the doldrums for most of the past decade.

Brisbane's short-term recovery will depend on whether Queensland enters a prolonged second-wave lock down. If this can be avoided, then the signs are good that the Brisbane market will recovery relatively quickly.

Arcadis Tender Price Forecast

	Adelaide	Brisbane	Canberra	Darwin	Melbourne	Perth	Sydney
2020	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
2021	-0.6%	-2.7%	-2.0%	-2.6%	-0.7%	-1.2%	-0.7%
2022	2.2%	4.0%	2.8%	2.7%	3.4%	0.3%	4.1%
2023	1.4%	3.0%	1.9%	2.5%	3.3%	0.5%	4.2%
2024	1.4%	4.1%	2.2%	2.3%	4.2%	2.6%	4.3%
2025	1.4%	4.2%	1.8%	2.2%	4.1%	2.3%	4.4%
TOTAL	**5.8%**	**12.6%**	**6.7%**	**7.1%**	**14.1%**	**4.5%**	**16.2%**

Current signs indicate that the construction sector is currently operating at two different levels. Firstly, managing and principal contractors are now showing signs of distress and increasing competitive tension as they look to reduce margin and management costs within their tender submissions.

In some cases, we have seen preliminaries and margin costs reduced by almost half as main contractors try to secure their short and medium-term pipelines. However, this is not the case at the trade contractor level. Recent tender activity indicates that trade contractors are certainly keener to engage in tender opportunities than they perhaps were 6 months ago.

However, this has not yet translated to reducing levels of trade costs. Further investigation and engagement with the contracting market indicates that a significant number of trade contractors within the commercial sector have relatively strong short-term pipelines of secured work.

Once these projects are completed towards the end of 2020 and the start of next year, we anticipate that trade contractors will then start to follow a similar trend to the main contractors. This is where negative inflation will start to be incurred.

Zoom into:
Arcadis 5-point project procurement plan

With multiple Government initiatives in place, the promise of economic recovery seems to be on the horizon. But how confident can we be that this promise will become a reality?

Risk awareness is at its peak and the potential for further disruption related to new waves of infections remains. Whoever dares to set up new contracts in these challenging conditions, will require a flexible approach to risk.

Risks related to lower productivity, COVID-19 disruption to works, and supply chain resilience could result in delays and increases in costs and will prompt clients to reconsider their own business needs. However, let us be clear, delays to projects and an aggressive approach to risk transfer by either side could be damaging both to clients and the supply chain. A different approach is needed, to make sure that projects succeed, as well as to ensure the long-term health of all sides of the industry, including client, main contractor, and the wider supply chain.

The industry is diverse, with the infrastructure sector being locked into frameworks, and commercial and housebuilding sectors being much more responsive to market trends. While there cannot be a one-size-fits all approach to project procurement, there are some core principles that can be applied across all sectors.

Increasingly we are recognising the urgency of engaging in collaborative conversations – even very difficult ones that involve trade-offs and compromise. Let's use these challenging times not only to strengthen the collaborative spirit of the industry but also to enhance procurement – increasing transparency as well as embedding some pragmatic thinking into contracts to increase project resiliency.

Our 5-point procurement plan sets out core principles for the effective appointment of project teams in a high-risk environment:

1. Consider the portfolio/program/project priorities

   Until the risk of disruption falls, clients should only consider starting projects that have a strong investment case. Clients should review projects across the portfolio and identify the highest priorities, for example, those that cannot be deferred for safety and service continuity reasons. Other projects should be rescheduled in line with their risk profile and investment case.

   Confirm that the original project value criteria still apply because new factors may need to be accounted for. For example, it may now be worth paying a cost premium for assurance around supply chain resilience if it increases the certainty of project delivery. By contrast, clients operating in the public sector may choose to accept a changed risk allocation with their normal supply chain as part of their role in accelerating economic recovery.

2. Put in place a suitable procurement strategy

   Post-COVID-19, the shared interests of contract parties will need to be optimised. Clients wanting to pursue projects in a riskier environment should consider a holistic strategy that addresses challenges related to the bidders' risk appetite, as well as impacts on the productivity and stability of the supply chain.

   The knowledge of the underlying position of the delivery team can be used by clients to define the balance of risk premium and risk retention they are prepared to accept. Look for ways to drive commitments to continuous productivity improvement from the very outset, through design (standardisation and Modern Methods of Construction), construction process, logistics and project management.

3. Engage with the supply chain

   Having access to a tested and trusted supply chain has always been a valuable business asset, and it is an absolute prerequisite when operating in times of heightened risk. Transparent and honest conversations with the supply chain about impacts on productivity and levels of risk that contractors are willing to accept will be particularly important.

4. Design an appropriate procurement event

   Even with construction demand likely to fall in the wake of COVID-19, clients will still need to work hard to get the best procurement outcome. Establish a commercially sound procurement process that is attractive to bidders. This will ensure an appropriate, managed level of competition.

   Greater supply chain participation (including Tier 2) and increased transparency will help to create a baseline that is sufficiently well-defined to give confidence to all parties. Be open to new procurement options and innovation, provided the focus is on simplifying processes and strengthening trust, rather than adding complexity. Consider, for example, including incentivisation mechanisms in the contract to increase productivity as COVID-19 restrictions are reduced.

5. Manage risks proactively and record events

   Only the strongest investment propositions should be taken to market during the crisis. Any client willing to enter the market in the new and challenging post-COVID-19 setting should take active steps to raise their game to ensure their expected return on investment, including:

   - Look for the widest range of opportunities
   - To proactively manage risks – both established and emerging.
   - Ensure that your team has the right skills and tools to provide greater control over program delivery.
   - Look to use technology to record events and analyse them regularly to see how they compare to the agreed baseline, and what the impact on the time and cost outcome could be.
   - Make sure all necessary corrections are implemented to enable program continuity across the project.

Spotlight on:
The Construction Sector Recovery Roadmap

Recent government announcements, including JobKeeper, have highlighted the role of construction in driving recovery. Yet beyond the political announcements, there is a more structured approach to recovery that needs to be developed by the industry.

Looking beyond the crisis

The successful rebound of the sector will depend, broadly, on a combination of urgent, short-term actions and strategic long-term thinking. Any recovery plan that is implemented needs to look beyond the immediate crisis with a view to delivering a more capable, professional, productive, and profitable sector. The outcome will provide clients with better value and better performing infrastructure and buildings. It should aim to use post-COVID-19 interventions to address some of the biggest challenges, such as reducing carbon emissions and improving the sustainability and resource efficiency of the sector.

Other priorities include delivering more and better housing, the acceleration of much-needed infrastructure within regional areas and increasing investment in skills and training at all levels through professional and vocational education and apprenticeships.

Current interventions emphasise the role the construction sector has in supporting a wider economic recovery. Construction contributes directly to regional economic recovery and prosperity, through high multiplier investments, relatively high earnings, fast cashflow and local supply chains. Building on our strengths in digital design and systems, manufacturing and materials could also increase Australian exports of products and professional services, targeting a global infrastructure market worth US $2.5 trillion a year.

The role of industry collaboration

The Construction Industry Council (CIC) in the UK has developed an ambitious proposition that the Australian construction sector could learn from. It considers not only the "usual suspects", i.e. clients and the supply chain across the buildings, infrastructure and repairs and maintenance sectors, but also a broader built environment and construction ecosystem.

As such, it outlines actions needed from the Government, local authorities, UK Research and Innovation, the Construction Industry Training Board and The Construction Leadership Council itself. Progress has been good and measures including the extension of planning consents, the publication of the procurement pipeline, the launch of a Talent Retention scheme and investment in retrofit have already been initiated.

The success of this undertaking will depend on each party committing to its tasks – big or small. Each action is equally important; whether confirmation of project pipelines by public sector clients or withdrawing the workforce from the UK Job Retention Scheme, whether it is a step by a local authority or by a small specialist company. In particular, the initial phase of the recovery will be about small actions undertaken across the industry – such as longer site operating hours, extended planning consents, prompt payments or retention of people. These small steps will enable gradual progress towards "bigger" tasks such as rebooting apprenticeships (including the development of distance learning tools), embedding the wider adoption of digital technologies, or exploring more collaborative business models and contractual terms.

Even for a sector that is accustomed to boom and bust, there has never been so much at stake; so much to lose but also so much to gain. This applies to Australia just as much as it does the UK. The Australian construction sector has the opportunity to ride out of the COVID-19 crisis on a wave of positive change, provided that the whole industry ecosystem is able to come together, commit and collaborate.

Expectations are high. And so they should be.

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Arcadis.

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