ARCADIS

December 2024

Labour Pains

Overview

In our previous Half-Year Market View, we suggested that the construction market was at its lowest point and that the only way was up. Despite this, construction costs have remained stubbornly high, underpinned by significant labour and skills shortages. 2024 has continued to be subdued across most markets and there is hope that construction costs may start to reduce, fuelled by future interest rate cuts. But is this wishful thinking? With a looming labour crisis, we take a look at the Australian market and try to understand what the potential impact of this will be.

Is the industry ready to bounce back?

Like other markets such as the UK, the Australian construction industry has been facing significant challenges including a period of uncertainty and economic turbulence since the end of 2023. While the Australian economy has shown resilience and promising signs of recovery, the construction sectors contribution has remained relatively stagnant, failing to significantly boost overall economic growth in the first half of this year. However, there are signs that the construction sector is starting to take the first steps on the road to recovery. But timing is everything, and there are several barriers that could delay an upswing and with it, future levels of inflation. Continued project approval delays, additional compliance and increasing client requirements are leading to further project deferrals due to ever increasing construction costs.

Economic growth has been patchy at best having risen from the "blink and you will miss it" technical recession that we endured in 2019/20. Since then, GDP has risen to a peak of 4.3% in 2021/22 before falling to 1.5% for the year to June 2024. The Reserve Bank of Australia appears to be forecasting increased, but tepid, growth through to June 2025 of 2.6% and 2.5% for June 2026. However, as previously highlighted, the recovery is consumption-led, and construction activity has been relatively flat.

Looking forward, the sector's pipeline continues to be significant – although this does appear to keep being pushed back and delayed. Current data confirms the findings of recent sentiment surveys, pointing to potentially better trading conditions in 2025. Contractors have reported significant delays and higher compliance costs and, despite an uptick in construction enquiries, conversions to sales are often being deferred due to increased costs. AI Group have confirmed that the latest Australian PCI indicator for construction eased by 18.3 points to land at -19.8. In overall terms, the indicator reached an all-time low in June 2024 and is now starting to recover.

Yet the bigger picture remains decidedly mixed. The RICS Global Construction Monitor, released at the end of July, indicates that construction activity in the second quarter of the year was slightly less than the previous quarter. This is supported by the latest data from the Australia Bureau of Statistics (ABS) which indicates that total construction work done rose just 0.1% from the previous quarter. For contractors, performance is relatively mixed. Laing O'Rourke have recorded a return to pre-tax profit following significant losses in the 2023.

Lendlease reported a $1.5Bn loss as it continues to exit from several of its international businesses so that it can focus on its core markets in Australia. This loss includes a $513M write-down from Bovis Construction, which Lendlease acquired in 1999. Insolvencies also remain at record levels, and this is expected to continue for at least the next two years.

The impact of interest rate cycles on the construction sector

In August 2024, the RBA governor Michele Bullock warned that rising material costs and trade shortages in the construction sector were making it difficult to get inflation back to target – and probably hence why the RBA has refrained from cutting interest rates. Lower interest rates should boost stagnating consumer sentiment, which in turn would spill over into the housing market. In what is becoming a significant housing crisis, the total number of dwellings *commenced* in the year to the March quarter fell by 9%. Conversely, the number of dwellings *completed* during the same period increased by 7.9% - demonstrating the highly volatile nature of the housing market. The fall in the commencement of new dwellings only serves to highlight the significant gap between what is currently being delivered and the housing targets that have been set by the National Cabinet.

These targets aim to deliver 1.2 million new homes over five years from mid-2024 – so the clock is now ticking. By the end of the first quarter of this year, more than 41,000 new homes had been delivered. Across the whole of 2023, the industry managed to deliver a total of 175,000 dwellings (equating to an average of about 44,000 dwellings per quarter). To meet the current ambition, the industry needs to deliver a minimum of 240,000 homes per year.

However, inflation is only part of the issue. According to the Productivity Commission, construction labour productivity fell by 1.8% in 2023. We are effectively building less, over a longer period, at a higher cost. This is the very definition of an unsustainable industry. Tackling the productivity challenge head-on will go some way to making up the shortfall.

In the commercial sector, investors are still relatively cautious, particularly in connection with large scale development. High finance costs continue to hamper viability, and developers are also finding it difficult to sell completed developments to recycle capital. There is certainly a cycle of investors looking to dispose of assets to realise returns and repay debt, as confirmed by CBRE and the Property Council of Australia. Investors are waiting for indications that the current repricing cycle has finished before deploying significant amounts of capital into the market. Further, just over 60% of investors, the bulk of which are private equity funds, real estate funds and REITs, indicated that they intend to retrofit existing buildings to be more sustainable or ESG-compliant.

Labour pains

The construction industry has been predicting a staggering deficit of skilled workers since the end of 2022. However, the latest data from the ABS shows that construction vacancies across Australia have been falling sharply since May 2023 – from just over 33,000 to 25,000 (equating a reduction of 24%). This could indicate that roles and vacancies are now being filled and that contractors are not necessarily facing the same challenges in finding quality people. The unemployment trends in the construction industry have remained consistent within a range of 2% to 3% in the last two years. While there are differing pictures within each state and territory, construction industry unemployment has increased nationally by 0.7% indicating that the labour and skills shortage has not quite hit.

In our view, this is just a reflection of the relatively subdued nature of the market for 2024 and not a precursor to a longer-term trend. Analysis indicates that the construction market is now at the bottom of the cycle and that reducing vacancies and increasing unemployment – however marginal – are supporting indicators of this scenario.

The size of the forward construction pipeline is still significant, across all the major states. As projects are released to market any available capacity will quickly be absorbed and construction vacancies will start to increase at a rapid pace. Forward estimates of above trend escalation for 2025 and beyond still stand – but industry capacity and labour shortages are only part of the story.

The rise of the three-day week

Before the pandemic, the construction industry operated on a six-day working week. Since then, the industry has largely operated on the presumption of a five to a five-and-a-half day working week. But the reality is that it has been much less. During the pandemic, and under reduced working conditions, construction workers became used to finishing early on a Friday morning and this trend has continued in the post-pandemic era. However, this adjustment has started to occur much earlier, with many construction sites practically deserted on a Friday, except for the management teams. While these observations are largely anecdotal it is a trend that is being recognised by a growing number of contractors across the construction sector.

These observations are supported by the latest data from the Master Builders Association and the Property Council of Australia, which indicates that productivity in the building sector on some sites has fallen to less than three days a week (2.8 days per week in fact) and this is now permeating into the civil infrastructure sector. Taking the total number of hours worked in 2023 and dividing that by the average construction workforce for that year, each worker delivered on average 1,658 hours.

Comparing this to the pre-pandemic environment in 2018, workers delivered an average of 1,675 hours per person. While a difference of 17 hours per person does not seem particularly dramatic, it doesn't highlight that the construction labour force was 12,500 larger in 2023 (119,400 workers on average) than in 2018 (106,900 workers). Had we been able to maintain the same number of hours per worker as we did in 2018, then this would have resulted in an additional 2 million hours across the year.

This is just further data that supports our view that the industry will continue to maintain above-trend escalation forecasts from 2025 and beyond. By progressing to what is effectively a three-day working week – and with productivity a rapidly declining picture – it is taking us longer to much needed homes and infrastructure. This of course adds up to higher costs for projects, further impacting the value for money equation.

The Arcadis Forecast

Future improvement in economic outlook, however slight, declining productivity and a strong forward pipeline validate our current forecast and place the spotlight firmly on the pace of recovery and its impact on contractor pricing strategies.

Introduction

Our introduction highlights that the market has softened considerably over the last 18 months, but that there is light at the end of the tunnel. Wider economic developments are expected to be supportive of growth, including the start of the US's own cycle of fiscal loosening. Despite some improvements in investor and consumer confidence, construction output remains flat. However, there are increasing signs that clients' attitudes are now beginning to shift and that there will start to be expansion in client activity during 2025.

Australia can also expect to benefit from a much-needed period of stability. With initiatives aimed at attracting new investment into renewable energy and other infrastructure, the construction sector will need to change its attention from survival in the present, to dealing with the consequences of growth in 2025.

Materials inflation remains in check

Materials price rises across many product categories have been filtering through for 6 months. In the initial phases of recovery, whilst the labour market remains relatively in balance, materials and shifts in procurement trends and pricing strategies are the most likely driver of inflation related to actual price increases and project de-risking.

With some parts of the supply chain nursing heavy trading losses, bidders will seek to add contingency pricing as soon as conditions permit or negotiate inflation risk sharing mechanisms.

According to the latest ABS data, residential construction costs have been impacted by upward trends across several material products. The biggest mover relates to electrical equipment, driven by electrical cables and conduits due to higher copper prices for manufacturing. Similarly, the cost of manufacturing aluminium has increased – impacting the cost of aluminium windows and doors. Ceramic products have also increased, underpinned by increased costs for clay bricks due to increased energy, labour and freight costs. However, for the time being at least, the non-residential segment is benefitting from some downward price pressure associated with steel prices. Looking at this in greater detail, the biggest inflationary pressures has affected the categories noted below.

Category	Change
Electrical cables and conduits	+7.9%
Aluminium Windows and Doors	+1.0%
Clay Bricks	+0.9%

By contrast, the steel market continues to show some signs of spare capacity for standard sections. Whilst some fabricators have seen their workload increase, risking capacity-driven inflationary pressure at the top of the market, the market for standard sections remains soft. For structures, matching fabricator capacity to job characteristics will be a major challenge for clients and their teams.

In summary, materials inflation has re-emerged as a key driver. Some clients are concerned that as demand recovers, gaps in production capacity will emerge. Manufacturers are reasonably confident that they can reestablish production capacity within just a few months. As a result, so long as the pace of recovery is steady, volume material production should keep pace. Fabrication capacity rather than primary manufacturing could be a bigger problem if workload grows quickly.

Labour costs – shifting balance

The Arcadis view is that labour costs are likely to be the main source of inflationary pressure in the next construction cycle. This is due to conflicting trends of increasing workload, tightening competence requirements and reduced opportunities for the sector to secure additional labour from overseas. In addition, reports are now circulating that Western Australia are offering cash bonuses for workers to relocate from the East coast of Australia to solve their immediate labour challenges. This will only serve in robbing Peter to pay Paul and doesn't address longer-term capacity concerns. The current migration system and policy framework needs a rapid overhaul to ensure that the skilled migrants that are needed can be identified, prioritised and processed quickly.

Until this happens, there will continue to be signs of a tightening labour market, even as immediate workload levels remain flat. Labour market data must be viewed with care due to survey quality issues, but the latest ABS release should ring alarm bells. Overall, the net change in workforce over 12 months is a reduction of 2.6% to 1.3 million. Long term comparisons are difficult to undertake or meaningful due to changes in the data, but it is worth noting that the workforce numbered 1.18 million before the pandemic. It would therefore appear that trends are going in the right direction, but this is well short of the numbers that will be needed to deliver the forward pipeline.

Construction wage growth (+3.5% annually) lags several other industries such as electricity, gas, water and waste services (+5%), education and training (+4.4%), mining (+3.8%) and manufacturing (+3.8%). However, the latest release of the Wage Price Index indicates that growth across industries stands at +3.5% over the year, underlining the relative strength of the sector's labour market. Whilst this data point doesn't suggest that a labour shortage is imminent, the recovery in wage growth is a sign that the recovery may already be driving up earnings.

Forecast – positive news confirms the inflation outlook

The past quarter has confirmed the resilience of the Australian economy and a strengthening construction recovery. Workload has not increased yet but the foundations for a better 2025 are falling into place.

Even with an improved order outlook, we do not expect to see a significant upturn in work on site before mid-2025, reflecting challenges in bringing forward residential projects and the timescales needed to bring forward the next phase of commercial and public sector schemes.

However, ahead of a material uptick in construction prices, we are seeing a further toughening of contractors' commercial approach to tenders, with many now highlighting that the current tendering market is more challenging than at the beginning of 2024. Discussions remain focused on risk allocation and contractual terms, although price levels are becoming a more common point of difference.

We continue to predict lower inflation in buildings markets up and until early 2025 and reiterate our higher inflation forecast for late 2025, 2026 and 2027. This has resulted in significant downgrading of total cost escalation over the next few years for both Sydney and Melbourne. However, Brisbane maintains consistently higher levels of escalation over the next few years due in part to the significant forward pipeline, the regionalised nature of the Queensland market, and the relatively shallow depth in terms of overall capacity and supply chain. Meanwhile, Perth has seen a significant uptick in escalation for 2024, which is reflective of the current boom cycle that the market is working through. This is supported by the ABS Producer Price Index which indicate the following for the first three quarters of 2024.

For infrastructure, we keep our view that the sector will see a 'K' shaped inflation trend, with relatively low levels of inflation in the rail and road sectors and higher levels of escalation for networks, driven mainly by demand and scarcity as large-scale programmes start.

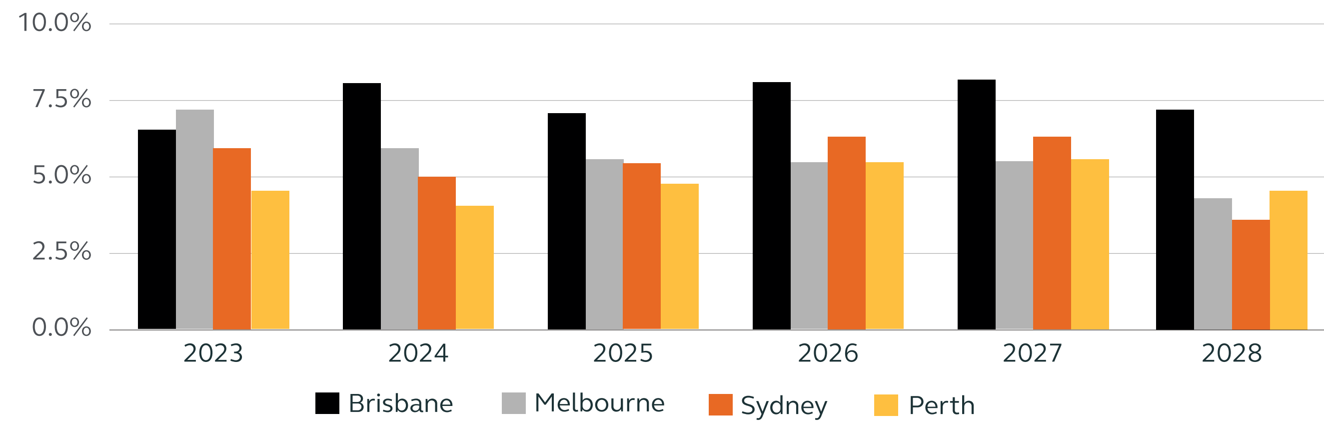
ABS Producer Price Index - Three Quarters of 2024

State	Change
New South Wales	+3.9%
Victoria	+2.4%
Queensland	+4.5%
Western Australia	+8.3%

Please note that the figures denoted in brackets reflect the forecast included in our previous Market View, which was released in June 2024.

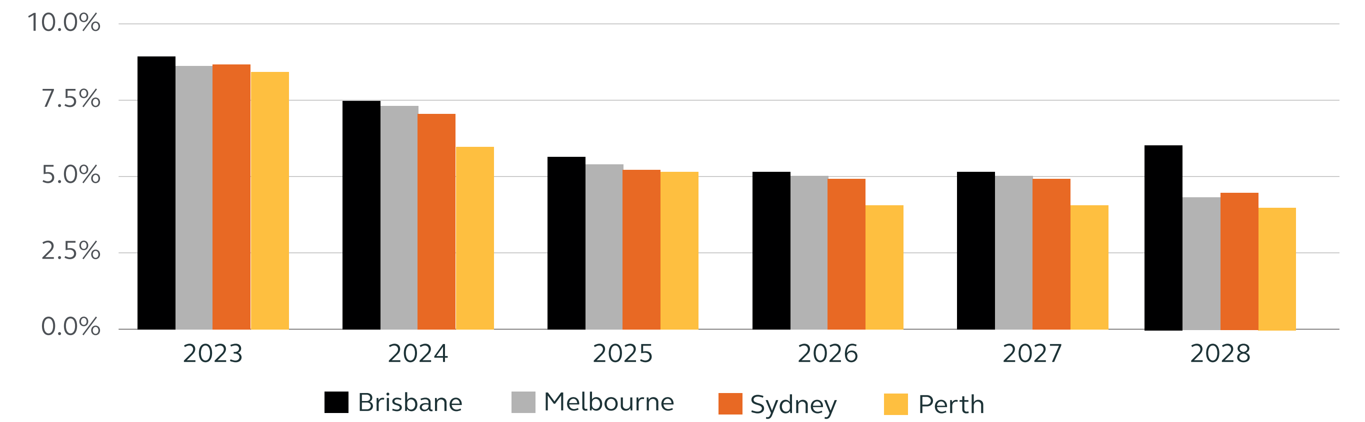
Arcadis Buildings Cost Escalation Forecast

	Brisbane	Melbourne	Sydney	Perth
2023	5.7% (5.7%)	6.5% (6.5%)	7.7% (7.7%)	3.8 % (3.8%)
2024	6.0% (5.2%)	3.2% (5.0%)	5.2% (6.5%)	11.1% (7.0%)
2025	6.0% (5.3%)	3.0% (5.0%)	4.6% (6.8%)	8.5% (4.5%)
2026	6.5% (5.8%)	3.5% (5.6%)	4.9% (6.1%)	8.0% (3.9%)
2027	6.5% (6.2%)	3.5% (5.8%)	4.4% (6.2%)	6.5% (4.4%)
2028	7.0% (6.2%)	4.0% (5.8%)	3.5% (6.2%)	4.5% (4.4%)
Total	**37.7% (34.4%)**	**23.7% (33.7%)**	**30.3% (39.5%)**	**42.4% (28.0%)**



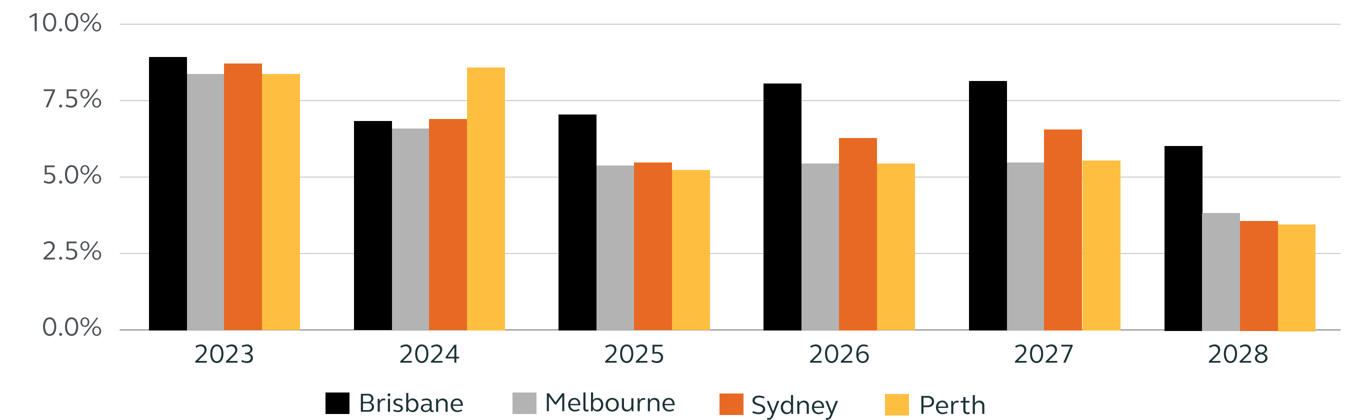
Arcadis Heavy Civil Infrastructure Cost Escalation Forecast

	Brisbane	Melbourne	Sydney	Perth
2023	7.0% (7.0%)	5.0% (5.0%)	5.8% (5.8%)	3.3% (3.3%)
2024	4.1% (4.1%)	4.0% (4.1%)	4.3% (4.3%)	3.3% (3.1%)
2025	6.0% (5.0%)	3.8% (3.1%)	5.5% (3.3%)	3.2% (2.5%)
2026	5.9% (5.5%)	3.4% (3.4%)	4.6% (3.5%)	3.8% (3.7%)
2027	6.0% (5.8%)	4.0% (4.4%)	4.2% (3.8%)	4.0% (4.5%)
2028	6.0% (5.8%)	4.3% (4.4%)	4.5% (3.8%)	4.0% (4.5%)
Total	**35.0% (33.2%)**	**24.4% (24.4%)**	**28.9% (24.5%)**	**21.4% (21.6%)**



Arcadis Rail Infrastructure Cost Escalation Forecast

	Brisbane	Melbourne	Sydney	Perth
2023	7.0% (7.0%)	5.0% (5.0%)	4.4% (4.4%)	4.5% (4.5%)
2024	4.5% (4.5%)	4.1% (4.0%)	4.3% (4.3%)	3.1% (3.1%)
2025	5.9% (4.3%)	3.8% (3.0%)	5.0% (3.3%)	3.2% (2.5%)
2026	5.9% (5.5%)	3.4% (3.4%)	4.0% (3.5%)	3.8% (3.7%)
2027	6.1% (6.3%)	4.0% (4.4%)	3.8% (3.8%)	4.1% (4.5%)
2028	6.2% (6.3%)	4.3% (4.4%)	4.1% (3.8%)	4.2% (4.5%)
Total	**35.6% (33.9%)**	**24.5% (24.2%)**	**25.6% (23.1%)**	**22.9% (22.8%)**



Bringing into focus: Construction markets by state

While there are many factors impacting the construction industry across Australia, each state continues to face local challenges as well as opportunities.

Queensland

Forecast Overview

- The Queensland construction market remains relatively busy, with the value of construction work done, in seasonally adjusted terms, 4.3% higher in the year to June 2024. Considering the pipeline of construction work that is anticipated to start by the middle of next year, it is likely that capacity issues and labour availability will hit here before other states. We have therefore upgraded our forecast to 6% for 2024 and 2025 respectively. As more projects start to hit the market in 2026 and beyond – particularly in connection with the 2032 Olympic Games, we anticipate that construction cost escalation will stay well above the long-term trend.

It's all change at the top

- Recently, there has been a state election where Queenslanders have decided to elect the LNP to government, displacing Labor who have been in power for close to a decade. It is still early days, but the Crisafulli Government has not wasted any time making several industry-related announcements. These include their commitment to running a 100-day review of the projects and investments associated with the 2032 Olympic and Paralympic Games, with a specific focus on transport infrastructure, a crackdown on unions by ensuring that they no longer have direct and unfettered access to the Office of Industrial Relations, and the temporary suspension of BPIC (Best Practice Industry Conditions).
- This last item has been particularly well received by the industry. The suspension does not apply to existing projects that are in construction or those that well advanced in terms of procurement. There has been growing concern and consternation across the industry that BPIC was adding needless cost and hampering productivity without any kind of return in value. The recent and substantial 26% wage increase over five years secured by the CFMEU in June had an immediate impact on projects, leading to challenges in maintaining cost projections and profitability. It will take time to understand the implications of this suspension. However, the current consensus is that this is a positive move for the industry.

Construction market dynamics

- Projects that received approval just before the recent government change are now under scrutiny as the industry navigates the potential implications of this new leadership. Uncertainty looms as stakeholders await clarity on how the new administration's policies and priorities will start to influence the planning and construction landscape.
- The persistent shortage of skilled labour continues to cast a shadow over construction projects, significantly affecting construction timelines and cost. As noted above, the construction market has remained relatively busy – but not overstretched. With a glut of major projects on the horizon getting nearer, there is now a growing concern that the market will exceed available capacity quite quickly from as early as the second half of next year.
- With a busy market, builders have an opportunity to be quite selective in which projects they spend their time focusing on. This has also led to the adoption of conservative pricing strategies, which reflects a deep-rooted concern regarding future capacity and weakening productivity. This cautious approach to pricing not only reflects the current challenges but also highlights the need for long-term solutions to enhance efficiency and profitability in the delivery of construction projects.
- Interstate migration is likely to continue, and may even increase, and will be required to facilitate the delivery of the current pipeline of major projects.

Stadium controversies

- The debate surrounding whether existing facilities should be upgraded, such as the Gabba or the Queensland Sports and Athletics Centre, or whether to deliver an entirely new stadium for the 2032 Olympic Games and future legacy remains a hot and much debated topic. The decision holds implications not only for the states sporting infrastructure but also for the broader construction industry.
- The announcement of a 100-day review of Olympic venues and associated transport infrastructure adds a layer of complexity to the ongoing discussion. Balancing the potential for a revamp of existing assets versus the delivery of new assets presents a strategic challenge that could reshape future construction priorities across the region. But time is running out, and the industry is in desperate need of some certainty in terms of assets will be prioritised and committed to.

Productivity challenges

- Both builders and subcontractors are facing new considerations in their pricing and are not as quick to accept risks associated with extreme weather and ongoing challenges to supply chains. Disruptions in connection with industrial relations is also a significant issue and there have been an increasing number of instances where builders are looking to remove or mitigate this risk as far as possible within their contracts. This evolving landscape demands a more nuanced approach to risk assessment on construction projects, particularly for clients.
- Larger projects grappling with resource shortages are experiencing inefficiencies and increasing delays in their construction schedules. The need for a more comprehensive workforce strategy to address labour gaps and enhance operational efficiency is increasingly evident in today's construction environment.
- With significant public infrastructure projects worth billions poised to commence, the current market's capacity appears to be on the cusp of a transformative period. Stakeholders are preparing for a potential shift in the construction landscape as these large-scale projects gear up for implementation, signalling a dynamic phase ahead for the industry.

New South Wales

Forecast Overview

- We have downgraded our forecasts for 2024 and 2025 based upon the relatively subdued nature of the current market. The latest ABS data indicates that escalation has hit 3.9% based on three quarters of activity, meaning that our Half-Year forecast of 6.5% for 2024 was relatively pessimistic. We have therefore used this as a basis to reassess our forecast for 2025 and beyond and have downgraded further from our Half-Year report. We believe that this will reflect the nature of the market, which will continue to be busy, whilst having a relatively deep supply chain that will be able to comfortably deal and cope with any sudden peaks.
- The Property Council's sentiment survey depicts a "tentatively positive" outlook across the property industry, highlighting a growing sense of stability and certainty in the construction sector. This is supported by our current forecast, which indicates escalation continuing at above long-term trend levels.

A Market revival?

- Clients across New South Wales, especially those operating in the residential sector, are showing signs of rekindling interest in projects that have been dormant for years. This is not just limited to the residential sector but is a similar trend that we are now seeing across the education sector, including tertiary. School projects are now starting to emerge into the construction market following a period of dormancy.
- This is reflected in the NSW Infrastructure Pipeline, where schools and health-related projects clearly dominate. However, many of the hospitals identified within the Pipeline are still in the Strategic Planning phase, and it is unclear as to when these are likely to come to market. Conversely, many school projects are now in the procurement phase, with construction likely to start in most case in the first half of 2025.
- The Renewable Energy sector is now gathering pace with Renewable Energy Zone projects such as Central West Orana and Hunter Central Coast and the Hunter Transmission Priority Project all due to commence construction between the start of 2025 and the start of 2026.

Despite the Infrastructure Review that was undertaken by the Federal Government in 2023, resulting in the cancellation or delay of several major projects, transport infrastructure remains a key sector for the state. Enabling works for Parramatta Light Rail Stage 2 will commence shortly, and Sydney Metro integrated developments at Hunter Street, Parramatta, Sydney Olympic Park and Pyrmont are all due to start during 2026.

Challenges and Opportunities in the Residential Sector

- The build-to-sell model in NSW faces significant hurdles, with builders remaining cautious due to extended liabilities. There are a limited number of contractors willing to engage in projects exceeding $150M, leading to larger head contractors stepping back and creating opportunities for lower tier builders to move up the chain. This has the potential to lead to quality issues, as it is unlikely that all these builders will have the capability to step up into a considerably larger category. In addition, there is considerable opportunity for builders to overreach and overcommit in what is essentially a higher weight class, potentially leading to cash flow issues and increasing insolvency risk. Clients are therefore encouraged to spend more time on due diligence activities to ensure that they engage with the right construction partner.
- Access to affordable housing continues to be a hot topic across the state. In response to these challenges the NSW Productivity Commission has recently made a series of recommendations from scaling back on solar access requirements to facilitate more efficient land use and housing development to reviewing minimum apartment sizes to promote housing diversity.
- There are also several significant projects that aim to positively impact the current housing crisis, such as the $4Bn Waterloo South social housing redevelopment. This project aims to redefine perceptions of social housing by delivering new homes more than 3,000 social and affordable homes, as well as retail spaces and public amenities, reflecting a transformative approach towards community development.

Labour Pains?

- Labour supply challenges persist across much of the state, but these stem from increasing market demand rather that from union pressures. This indicates a relatively complex dynamic that is influencing construction operations and project timelines.
- With the negotiations for the updated Enterprise Bargaining Agreements (EBA) now concluded, there is potential stability over the next five years. However, a substantial portion of the market – such as the residential sector – remains outside of these agreements.
- There is a risk that labour and skills could start to look at South East Queensland as a viable alternative – particularly due to the strengthening pipeline and the perception of greater options in terms of affordability. Should this occur and in great numbers, then that would have a detrimental impact on the NSW construction industry's ability to deliver the current pipeline.

Victoria

Forecast Overview

- It is amazing how much can change in a relatively short period of time. The best way to describe Victoria's construction sector is lethargic. This is marked by a considerable slow-down in public sector projects, with limited viable opportunities for private developers. In our previous Half-Year Market View report we anticipated that escalation for 2024 would reach 5%. The reality is that escalation has declined considerably as the year has worn on – from 1.1% in the first quarter to just 0.4% in the third. Therefore, we have downgraded our assessment to 3.2% for Buildings and an average of 4% for Infrastructure.
While construction costs seem to be stablising – at least for now – this has been mirrored by stagnating revenues and income streams, indicating an extremely challenging environment. The challenge for Victoria is a crippling level of confidence in the forward pipeline and, until this changes, we have adjusted our forecast for 2025 and beyond to more closely align with the long-term trend and better reflect the current uncertainty.

Transport Infrastructure No Longer a Priority

- This uncertainty is characterised by what is currently happening across the infrastructure sector. Up to twelve federal and state rail projects have been cancelled to date and the future of Suburban Rail Loop is far from known or guaranteed. The Victoria section of Inland Rail is due to be completed soon, but the majority of this is a retrofit of existing infrastructure rather than the creation of new rail assets.
- There is some light at the end of the tunnel, if you pardon the pun. With $1.8Bn investment to build, maintain and upgrade schools across the state, as well to deliver on previous commitments to create 100 new schools by 2026, there is still a lot of opportunity in the market. However, this program of investment is well behind where it needs to be, and the expectation is that the delivery of education infrastructure needs to pick up sooner rather than later.

A Reverse in Fortune for the Residential Sector?

- The decision by the state government to reduce stamp duty on off-the-plan apartments, units, and townhouses for a year aims to stimulate home building and alleviate housing pressures by providing financial relief to purchasers. By offering savings to buyers and potentially reducing the overall cost burden associated with property purchases, the stamp duty concession has the potential to encourage more individuals to enter the property market, thereby boosting demand for residential units.
- While the reduction in stamp duty may lead to a short-term increase in demand, its direct impact on housing supply may be more nuanced. Increased demand could spur developers to accelerate project timelines and commence new developments to cater to the growing interest from buyers seeking to take advantage of the temporary savings. This heightened demand, coupled with improved affordability for buyers, may indirectly contribute to a gradual increase in housing supply over time as developers respond to market signals. However, the question remains as to whether this will be enough as lenders are becoming increasingly stringent in their practices.

Union Impact on Labour

- Following the recent conclusion of EBA negotiations, labour costs are anticipated to increase at 5% annually over the next four years, with this posing significant challenges for the Victorian construction market. Despite the current industrial relations environment, it is unlikely that labour costs will start to fall significantly as wages will need to remain high for Victoria to be competitive with neighbouring states that have stronger project pipelines – particularly Queensland.
- Potential reforms under the current CFMEU administration may influence labour competitiveness, with the industry awaiting clarity on the extent of these changes. These changes result in continued industrial action on major project sites, disrupting timelines and impacting efficiency further. In contrast to this, reductions in labour costs and the reduction of industrial advocacy may influence the business environment and the overall attractiveness of the construction market to investors and developers.

Is Melbourne Still Attractive to Investors?

- Despite the current challenges, Melbourne maintains its appeal for capital investment – although this is now considerably more cautious than in recent years. Melbourne's lead in the nation's build-to-rent market and the tight industrial market with less than 2% vacancy rates underscore the city's investment potential. Notably, office transaction volumes experienced a rebound in the third quarter, indicating resilience and interest in commercial real estate in the region.
- However, projects just aren't stacking up because of increased construction cost levels and the cost of borrowing also remaining high. Many private sector developments have therefore stalled. The current taxation and investment environment across the state is making it increasingly difficult for developers to obtain the financing needed to get projects out of the ground.
- One sector that continues to drive significant investment is Data Centres, with a substantial speculative developed west of Melbourne. Investors are finding it easier to purchase land here and opportunities to get the requisite levels of power needed to site is currently far less challenging and expensive than it is in Sydney. However, capacity is currently being taken up across the network and diverting sufficient power to project sites will quickly become a more challenging prospect.

Western Australia

Forecast Overview

- In complete contrast to Victoria, costs in Western Australia have skyrocketed. In our Half Year Market Review, we forecast that construction costs would rise to 7.0% in the buildings market but would be a little more subdued in infrastructure. This has largely played out, but the results from the first three quarters of 2024 have been significantly higher than our expectations, equating to a total of 8.3% according to the latest ABS data. This has driven an upgraded reforecast of 11.1% for 2024 and is significantly higher than general market expectation, which sits around 5%, and well above 2023 escalation levels (3.8%). This demonstrates the highly volatile nature of the WA construction market, making it one of the most difficult to anticipate with any real level of accuracy.

Rise of the Megaprojects

- This forecast is underpinned by the states construction sector which is abuzz with new megaprojects like the $5Bn Perth Airport development, the $1.8Bn New Women and Babies Hospital, and the $3.8Bn Burswood Point urban project. There is also ongoing investment in social infrastructure, with $839M and $355M committed respectively in health and education. It is unclear whether the delivery of these projects is achievable with the current skills and labour shortages across the industry – which are probably more real here in WA than in other states currently. The timing of government-led projects and infrastructure may need to be reviewed to ensure that they are not crowding out investment in the private sector or other priority areas such as housing.
- The state government's infrastructure program is ambitious, with recent announcements confirming $12.1Bn of additional investment. Transport infrastructure continues to underpin much of the civil infrastructure market. However, many of these projects have either been fully procured, are close to completion, or have been pulled altogether due to budget constraints and viability issues. Either way, it is anticipated that future spend on transport infrastructure will likely be less than in previous years.
- Rapid advancements in defence spending, highlighted by the establishment of a defence precinct in WA's Henderson Shipyard, signify substantial investments that are poised to bolster defence capabilities over the next two decades. This initiative is expected to create thousands of jobs and inject billions into the economy – further reshaping the construction landscape.
- The Cook Government has recently introduced the Big Contribution Policy for non-residential major projects, which offers up to $750,000 to builders to cover tender costs on projects over $100M. This aims to reduce the burden of extensive bid costs for contractors as well as encourage more contractors to tender for a growing list of projects in healthcare, education, and corrections. This is setting the stage for increased future levels of project activity.

Labour – the pain is real

- Labour and skills shortages continue to plague the industry and is one of the driving factors of the increased levels of cost escalation in 2024 due to the high demand associated with a growing pipeline. To combat the 13,000 workers that are currently needed across the state, the Cook Government has been actively looking to attract construction workers from the eastern states by offering incentives such as relocation packages. It remains to be seen how much of an impact this will have on the local workforce. What is clear is that this is a much larger and longer-term issue, and robbing Peter to pay Paul is a just a quick fix.
- In recognition of this, the Cook Government is now looking to reduce the number of competing projects through a process of prioritisation and staggering key investments so that the market can better respond and deliver the state's infrastructure.

Housing Strategy

- The recently launched WA Housing Strategy targets connecting 150,000 households to homes by 2030, with a focus on achieving a 6% net increase in social housing. Despite this ambitious plan, the disparity between targets and the actual number delivered continues to grow. In the June quarter, less than 4,000 homes were built, underlining the significant challenge in meeting housing demands and the need for an acceleration of effort and new ways of working.

Zoom into:

Balancing risk appetite and exposure

One of the paradoxes of the current market is that, even as work opportunities have remained thin on the ground, contractors have maintained a tough stance on their contract terms. Our analysis considers why this is happening and how risk exposure can be managed to make projects work.

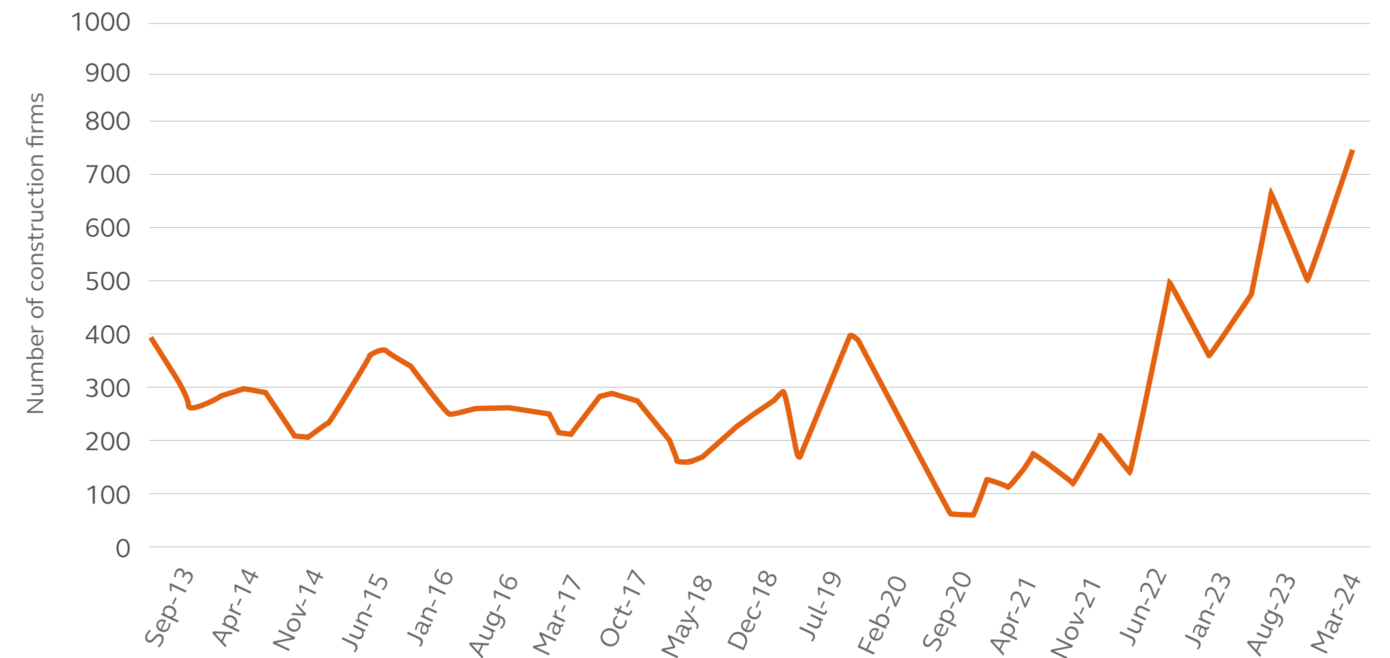
There has been a narrative across the construction industry for quite some time that highlights a growing problem with the allocation of contractual risk. Across most markets in Australia, there is an ever-increasing mismatch between the risk exposure associated with major projects and the availability of Tier 1 contractors with the appetite, skills and balance sheet strength to do the work. This situation is partly a result of the scale of projects that contractors are expected to deliver, but also the consequence of bruising trading conditions since 2020 which have left many contractors nursing substantial losses.

Large high-value projects are hardly a new phenomenon in Australia, but the geographical spread of large building contracts has expanded, particularly on the back of transport infrastructure investment in both major cities and regional areas. Large projects concentrate both opportunity and risk for head contractors; those with a turnover of more than $1Bn account for Tier 1 contractors – but this is hardly a scientific measure. A better metric would be Total Project Value delivered annually and, according to the latest Construction League Tables from the BCI, the Top 10 contractors in Australia are as follows:

Table 1 Construction League Table

Rank	Firm	Number of Projects	Average Project Value (AUD)	Total Project Value (AUD)
1	John Holland Group	14	$486,642,857	$6,813,000,000
2	Multiplex	12	$227,268,916	$2,727,226,993
3	Built	102	$25,609,952	$2,612,215,096
4	Icon	21	$102,915,055	$2,161,216,158
5	ADCO Constructions	26	$78,609,183	$2,043,838,759
6	Hansen Yuncken	22	$81,740,091	$1,798,282,000
7	Hutchinson Builders	108	$11,126,307	$1,201,641,110
8	Lendlease	14	$80,879,786	$1,132,317,000
9	Hindmarsh	15	$65,681,850	$985,227,752
10	FDC Construction & Fitout	38	$23,754,221	$902,660,393

Source: The BCI Construction League



Source: ASIC

Size is not the only factor affecting project risk. More often contractors are being asked to carry the load of design management and finalisation and, consequently, have needed to be more proactive in managing this risk through their direct control over the design solution and the supply chain. Where more of the work is subcontracted to specialist contractors, clients are likely to find that their head contractor has less appetite to underwrite the process risk, for example by excluding time-based penalties.

The welcome trend towards retrofit and circular economy principles has also seen far more work with a building condition risk exposure, particularly in the commercial sector. Clear data demonstrating this is difficult to come by, but there is anecdotal evidence suggesting that, across most capital markets, there is significantly more retrofit and repurposing projects as new build schemes. Retrofit schemes are typically procured using a design and construct contract with the expectation that typical existing building problems associated with fabric condition, obstructions, asbestos contamination and temporary works will be solved and underwritten by the contractor and the supply chain.

As the competition for contractors willing to carry these risks increases, clients may find themselves having to share some of the existing building risk or having to invest in advance in risk reducing survey work.

Finally, a surge in insolvencies in the sector in the last 12-18 months has had far more impact on main contractors than clients as they manage the impact of subcontractor failure against the background of fixed cost and time programmes. The latest insolvency data from the Australian Securities and Investments Commission (ASIC) shows that business failures in the construction sector remain at an elevated level. In the year to September 2024, there were 3,090 construction-related insolvencies. Between 2014 and 2019, the average number of business insolvencies across the sector equated to 389 per quarter. Since the start of 2020 this metric has increased by 19% to 463 insolvencies per quarter. Discounting the pandemic altogether, and analysing this data from mid-June 2022, insolvencies have increased by 68% per quarter since pre-pandemic levels, equating to a staggering average of 653 companies per quarter.

Many of these will involve sub-contractors and suppliers. Head contractor insolvency is of course a critical concern for many clients but is a relatively rare event. By contrast, the probability of sub-contractor failure is much greater and the management of impacts more complex, particularly as guarantees become more expensive and harder to obtain against smaller contractors.

The overall result is the potential for less industry capacity in terms of contractors willing and able to bid for projects. This could also result in a concentration of risk on a smaller number of contractors with the financial strength to thrive. Well-positioned, profitable contractors with a strong balance sheet will increasingly be able to negotiate on their commercial terms, meaning that over time a more balanced risk transfer will evolve. This could either be based on the procurement route adopted such as Managing Contractor vs. Design and Construct or through the detailed terms of the agreement and the carving up of the risk allocation associated with ground condition, relevant events, allowable change and other known unknowns.

Steps to optimise project risk allocation

Clients will have to work hard to secure their preferred risk transfer in a market where the supply of high-risk opportunities can be expected to exceed the capacity of the supply chain willing to take on the liabilities. As protections available to clients provide less cover, the result will be a rebalancing of risk transfer. Steps that clients can consider in balancing risk appetite and exposure include:

1. **Early market testing.** Proactive marketing of the project as an opportunity, including the testing of different contract models. Clients should understand that the pendulum has well and truly swung to the side of the contractor, who has access to a substantial amount of market opportunities. The risk of potential tenderers walking away from your project is as high as it has ever been and will likely occur if the contract or risk allocation is deemed to be unfavourable.
2. **Contract design.** Consideration could be given towards a balanced risk transfer in a lump sum contract, for example in connection with payment or with respect to sub-contractor exposure to indemnities and liabilities.
3. **Contractor selection.** Financial due diligence can be undertaken in greater detail including reference to current trading as well as published accounts. The willingness to accept a contractual risk balance could also be evaluated.
4. **Active de-risking.** Including the completion of surveys and /or site investigations as part of the procurement process to reduce the extent of open risk exposure in the contract and the inclusion of inflation sharing mechanisms including provisional sums.

Spotlight on:

Industrialised Construction – lean and mean or a costly indulgence?

In the slowly evolving world of construction, the buzz around Modern Methods of Construction, or "industrialised construction" as we are now beginning to think of it, is louder than ever. But what exactly are these methods, and are they the lean and efficient solutions they promise to be, or just another costly indulgence?

What is Industrialised Construction?

Typically referred to as Modern Methods of Construction (MMC), Industrialised Construction refers to innovative techniques that aim to improve efficiency, quality, and the sustainability of projects. These methods often involve off-site construction, modular building, and the use of advanced materials and technologies. When used effectively, it will be the construction industry's answer to the tech revolution.

The Lean Side of Industrialised Construction

One of the biggest selling points of Industrialised Construction is speed. Traditional construction can be a slow and labour-intensive process, but advanced techniques and processes like modular construction can significantly cut down on time. Imagine building a house in a factory, piece by piece, and then assembling it on-site like a giant Lego set. This not only speeds up the process but also reduces the risk of delays due to weather or other on-site issues.

While the initial investment in Industrialised Construction is inevitably higher, the long-term savings can be substantial. Faster construction times mean lower labour costs and, potentially, earlier project completion, which can translate to quicker returns on investment. Plus, the precision of factory-built components can significantly reduce waste and the need for costly rework.

Industrialised Construction is also a champion of sustainability. By using advanced materials and techniques, these methods can reduce the environmental impact of construction. For example, modular buildings often have better insulation and energy efficiency, leading to lower operating costs and an overall smaller carbon footprint.

The Costly Indulgence Argument

Despite the long-term savings that are on offer, the upfront costs of Industrialised Construction can be daunting. Investing in new methodologies and in new technologies, training, and equipment can be expensive.

For smaller firms or projects with tight budgets, this initial outlay might seem like a risky gamble. It also requires a long-term view and plan for future projects to be designed on a similar basis to take advantage of the initial investment. Unfortunately, the industry does not have a reputation for being innovative and forward-thinking and the progression of future projects will depend on the perceived success (or failure) of the initial investment.

While modular construction is great for standardisation, it can be less flexible when it comes to customisation. If a project requires unique designs or last-minute changes, traditional methods might be more adaptable. This can be a significant drawback for bespoke projects or those with evolving requirements.

Despite how long terms such "modern methods" or DfMA (Designed for Manufactured Assembly) have been part of the construction lexicon, they are still relatively new and not everyone in the industry is on board and there is resistance from stakeholders who are accustomed to traditional methods. Convincing clients, contractors, and regulators to embrace and invest in these techniques continues to be a challenge, slowing down broader adoption and increasing construction costs across the board.

Real World Examples

There are plenty of success stories that highlight the benefits of Industrialised Construction. For instance, the construction of the Wolverhampton Interchange in the UK used modular techniques to deliver a high-quality project on time and within budget. Similarly, Lendlease's use of MMC in their Barangaroo South development in Sydney showcased how these methods can achieve impressive sustainability and efficiency goals.

However, not all Industrialised Construction projects have been smooth sailing. The Grenfell Tower tragedy in London raised serious questions about the safety and regulation of these methods and highlights the need for rigorous standards and oversight to ensure that the benefits of Industrialised Construction do not come at the expense of safety.

Recent data shows that the adoption of Industrialised Construction is on the rise globally. In Sweden, around 45% of all new homes utilised some form of offsite construction, with the rate for single-family homes to 80% of traditional construction methods.

Japan, another leader in this space, produces between 150,000 and 180,000 homes annually using these methods.

And it doesn't stop there. The global market for Industrialised Construction is expected to grow significantly and, by 2025, it is projected that 50% of all construction projects will use offsite or modular manufacturing and 3D printing, with prefabricated modules accounting for up to 25% of the construction. Reports and analysis indicate that Industrialised Construction can lead to a 30% improvement in the speed of construction and a 25% reduction in costs. These efficiency gains are driving more companies to explore and adopt these innovative methods.

The Future of Industrialised Construction

The future of Industrialised Construction looks promising, with continuous advancements in technology driving innovation. 3D printing, for example, is making waves in the construction industry, offering the potential to create complex structures quickly and cost-effectively. As these technologies mature, the cost barriers are likely to decrease, making it more accessible to a broader range of projects.

Governments and regulatory bodies are also starting to recognise the potential of Industrialised Construction. Policies that support sustainable building practices and innovation can help drive the adoption of these methods. For instance, the Australian government's National Construction Code includes provisions that encourage the use of MMC to improve building performance and sustainability.

So, is Industrialised Construction mean and lean or a costly indulgence? The answer, as with many things, lies somewhere in between. While it offers significant benefits in terms of speed, efficiency, and sustainability, the high initial costs and challenges in market acceptance cannot be ignored. However, with ongoing technological advancements and supportive policies, the future of Industrialised Construction looks bright.

In the end, whether it is the right choice depends on the specific needs and constraints of each project. For those willing to invest in the future, Industrialised Construction can be a game-changer, offering a smarter, more sustainable way to build. For others, traditional methods might still hold the key. Either way, the construction industry is on the brink of a revolution, and it's an exciting time to be a part of it!

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