

REVIEW OF AUSTRALIAN CONSTRUCTION MARKET CONDITIONS

MARCH 2013



Decline in mining activity in the final quarter of 2012 is now having an impact in both Queensland and Western Australia where mining companies are reviewing expansion and development plans in the face of falling profits.

Commercial and residential construction continues to contract and the pressures we commented on in previous Reports in relation to the dangers inherent in tendering at cut-throat levels are only increasing. Across all states, our offices are experiencing extremely keen pricing as contractors remain in survival mode desperate to retain some level of turnover. Our Sydney office reports continued aggressive competitive tendering at levels resulting in contractor failure and our Adelaide, Canberra and Hobart offices are experiencing tender pricing at rock bottom levels.

Following a survey of construction business leaders, The Australian Industry Group says CEOs expect another year of contraction with the majority saying they will have to lay off staff. BCI Australia predicts that construction activity will remain weak due to reduced public sector spending, a high dollar, tight corporate budgets and tough lending criteria.

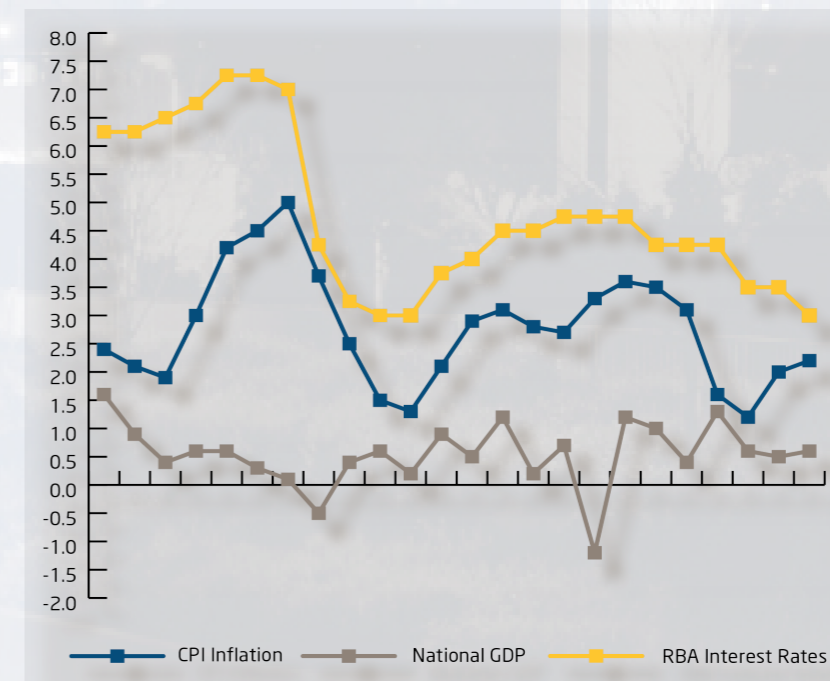
With the Federal Government going into survival mode and a lengthy period of campaigning leading up to the election in September, it is unlikely that there will be any improvement in confidence or any increased demand in the construction sector.

Our tender price escalation forecasts for 2012 proved to be fairly accurate with New South Wales, Victoria, Queensland, Australia Capital Territory and Western Australia trending at levels close to zero. South Australia, where we predicted a fall in prices of 10% has seen tender levels drop by even more than 10% in some sectors with little signs of any rebound.

Our forecast trends show little uplift over the balance of this year and through 2014 with an expectation that each state will experience greater increases towards 2015.

NATIONAL ECONOMIC INDICATORS

- GDP expanded 3.0% from December 2011 through to December 2012.
- CPI rose 2.2% over the year ending December 2012. This compares with a rise of 3.1% through the year ending December 2011. The downward trend over the last four quarters (2.0%) appears to be reversing with inflation currently trending around 2.2%.
- The Australian dollar traded at parity with the US Dollar throughout 2012 and was trading at approximately \$1.03 in March 2013.
- The seasonally adjusted Australian unemployment rate has increased since our previous report (September 2012). The rate is currently 5.4% in the ABS January 2013 data.
- During 2012, the RBA reduced the official cash rate by a total of 125 basis points. The RBA's current Cash Rate is 3.0%.

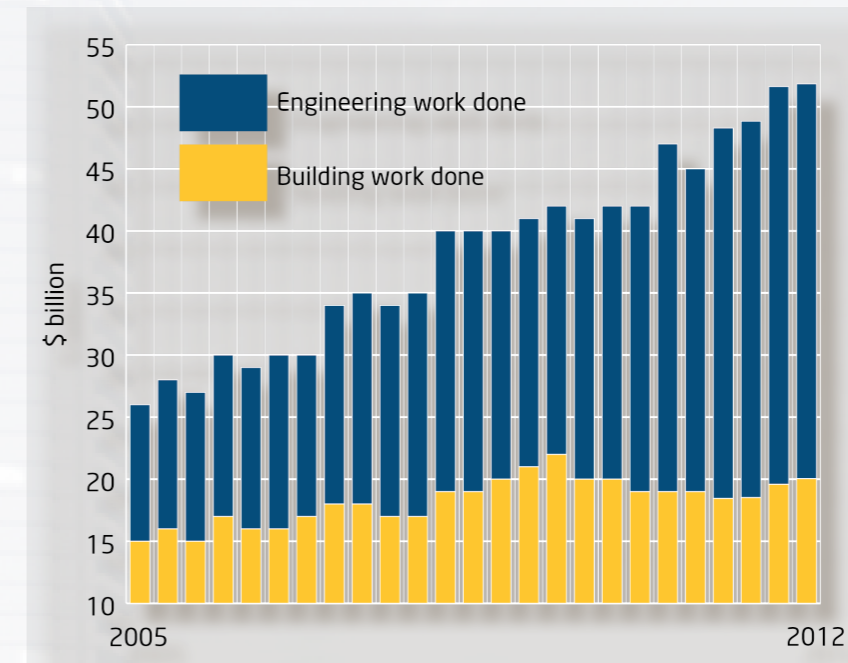


National GDP measure: seasonally adjusted quarterly % change
Source: RBA; ABS; Quarterly trend review on GDP, CPI inflation, RBA cash rate.

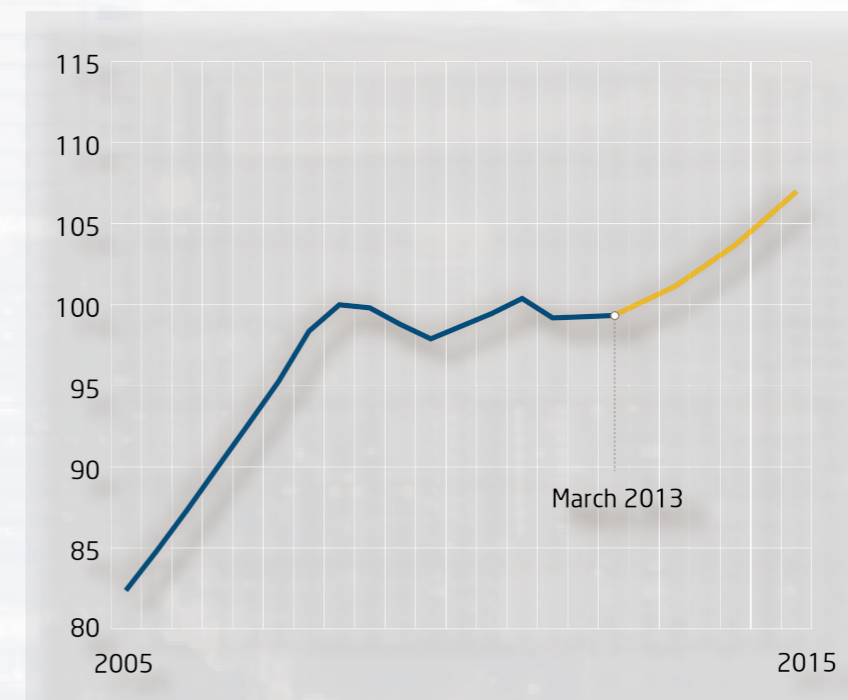
NATIONAL CONSTRUCTION INDICATORS

- The total value of construction work done increased by 14.9% in the 2012 year compared to the 2011 year.
- In 2012, the seasonally adjusted estimate for 'building work done' decreased by 1.4% compared to the previous year. The last two quarters of 2012 show a 4% increase for each quarter.
- The seasonally adjusted estimate for 'engineering work done' in 2012 increased by 24% over the previous year. The December 2012 quarter records a decline of 0.69% from the September quarter.
- Of the 'total construction work done' in the amount of \$200,286 million, 'building work done' represents 38% of total construction work done while 'engineering work done' represents 62%.
- Engineering work done as a percentage of total construction work done has continued to increase since the December 2010 quarter.

VALUE OF CONSTRUCTION WORK DONE IN AUSTRALIA (\$ BILLION)



WT PARTNERSHIP TENDER PRICE ESCALATION FORECAST - AUSTRALIAN AVERAGE



The above graph index is set at 100 for September 2008. Recorded data and forecasts are based on tenders for large building construction projects (value \$20 million to \$300 million).

State by State Commentary

NEW SOUTH WALES

The building construction sector in **NEW SOUTH WALES** continues to struggle into recovery, with a minor increase in construction commencements in residential and non-residential sectors from the same period of 2012.

Commercial vacancy rates have dropped to the lowest in years, but the demand appears to have been immediately absorbed by major CBD commercial developments currently under construction.

Aggressive, competitive tendering by contractors in all construction market sectors continues, in particular the mid-sized residential sector, which has already seen several well established builders going into administration in the past 12 to 18 months. However, land release areas are experiencing very positive sales outcomes.

Strong demand for rental properties, and an apparent undersupply of housing, especially in inner city locations, has not yet resulted in an increase in residential construction, recovery in this sector is not expected until at least the end of 2013.

Changes in January of this year to the *Building Code 2013 (Federal Code)* under the *Fair Work Building Industry Act 2012 (Cth)* as it relates to enterprise bargaining agreements may also place upward pressure on labour costs. The full extent of this however will not be totally understood until the respective guidelines and policies of both Federal and State Governments are in harmony.

Transportation features heavily in the NSW State Government's spending plans with a number of major projects identified in its *Long Term Transport Master Plan* coming online. The SWRL (Glenfield to Leppington Rail Line) is in the construction phase, the NWRL is now being tendered for station buildings, rail, rolling stock, tunnelling, civil and viaduct packages, light rail projects are being investigated and major road upgrades and extensions are being planned. Resource related construction work has slowed as the demand for coal eases and the investigation into NSW prospects for LNG comes under pressure from landowners.

There is an air of confidence that things are starting to improve, with low interest rates and a very low base starting point - the construction sector has to experience substantial growth soon.

We are projecting an average cost escalation of 1.5% for 2013, and an average of 3.0% per annum for 2014 and 3.5% for 2015.

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Nick Deeks (Sydney)

VICTORIA

In **VICTORIA**, tender markets across the board returned competitive results in the last quarter of 2012. Established Tier 2 and 3 contractors are actively competing for projects which suggests any rises in material and labour costs are still being absorbed by discounted head-contractor and sub-contract margins.

Developers continue to request preliminary feasibility exercises for a variety of higher density residential and mixed-use

projects, though anecdotally, pre-sales are now harder to come by than they were 18 months ago.

There are a number of larger retail centre expansions due to be tendered in the second quarter of 2013 as well as a volume of work at Melbourne Airport.

Government projects in the health and civil infrastructure/port sectors are also to be tendered, however on-site

activity is not expected to commence until the third and fourth quarters of the year. While there is expected to be a volume of work in the market, it is likely to be below the recent high capacity and as such we are not forecasting higher levels of cost escalation.

We forecast tender price escalation to be in the order of 2.0% per annum through 2013, 2.75% in 2014 and 3.0% in 2015.

AUSTRALIAN CAPITAL TERRITORY

With the announcement of a General Election for September, the immediate outlook for the already declining construction market in **AUSTRALIAN CAPITAL TERRITORY** is not promising.

Prospects of further staff cuts by both the current and future Federal Government as part of their efficiency/austerity measures have added to fears of further tightening in the market with the trend of large investment projects being postponed or shelved continuing.

Due to ACT Government budgetary measures, new State Government projects remain thin on the ground with the exceptions of the ongoing infrastructure works around Canberra and the redevelopment of the ACT health sector which includes the Canberra Hospital.

In the face of rising labour and material costs, builders continue to discount preliminaries, overheads and margins in order to remain competitive.

In the residential sector, an influx of developments has pushed Canberra's residential rental

market to new levels of supply with discounted rents beginning to emerge. The vacancy rate is now approaching 5% with more properties on the rental market now than in the past 15 years. Office vacancy rates have risen in the past few months and are now trending at around 12%.

It is anticipated that tender prices will continue to be kept throughout 2013 rising to 1.5% in 2014 and up to 3.0% in 2015.

SOUTH AUSTRALIA

During late 2012 we noted that there had been an extraordinary drop in pricing levels in **SOUTH AUSTRALIA** and there was much speculation over whether there would be a correction in the short term or whether the pricing drop would have a longer term impact. It appears that the latter situation will prevail.

Over the past few months, we have witnessed a steadying of tender pricing, which was necessary given the dramatic falls during 2012. However, we have not witnessed any significant correction and tender pricing on the whole still reflects the levels that we forecast in our last report, which was a net 10% reduction in tender price levels during 2012.

There continue to be relatively few public sector projects as compared to the pre-BER period and the financial problems of the State Government are regularly aired in the media. State debt is at levels that prompt comparison with the State Bank collapse in 1991 and ratings agency Moodys reported in January 2013 that South Australian debt is among the fastest-growing in the nation. Aims to keep the State Government debt below 50% of revenue appear to be doomed and completion of the new Royal Adelaide Hospital in 2015 will see an associated increase in taxpayer debt, with the result that State debt may

rise to 75% of revenue according to Moodys. Standard & Poors has warned that gross debt may rise to as high as 95% of revenue by 2015. Both Moodys and Standard & Poors have revoked South Australia's Triple A credit rating based on spending and borrowing forecasts.

Private sector investment is generally limited to owner-occupiers and we are seeing very few feasibility studies, which is a sign that speculative developers are struggling. Overseas investment, principally from China, in South Australia is very cautious and hindered by developers' expectations that construction costs should be even lower than they are. In addition, local experience suggests that financiers may be imposing harsher conditions, such as higher pre-sales, on Chinese-funded developers.

The impact of mining sector investment, which is often touted as being the State's saviour (notwithstanding BHP Billiton's cancellation of plans for Olympic Dam during 2012), continues to have no effect at all on the normal building and civil engineering construction markets.

As a result, and perhaps not surprisingly, pessimism reigns now in the South Australian construction market and we see no sign of any recovery in either optimism or workload during 2013.

We anticipate escalation rates of 1.0% for both 2013 and 2014 and 2.0% for 2015.

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Tony Brewster (Adelaide)

SOUTH EAST QUEENSLAND

Tender price levels in **SOUTH EAST QUEENSLAND** continue at cut throat levels with fierce competition prevailing in a diminishing construction market.

Tender levels are under pressure from rising labour costs in addition to material cost increases. Outside of the mining and infrastructure markets, margins and price cutting are prevalent. BIS Shrapnel, in its 2013 Major Projects Report predicts that the amount of construction work on major projects will fall by over 40% over the next four years (some \$7.6 billion).

The resources sector, which has buoyed the Queensland economy for several years now, is forecast to decline as profits from iron ore, coal, oil and gas continue to plummet in the face of rising costs and falling commodity prices.

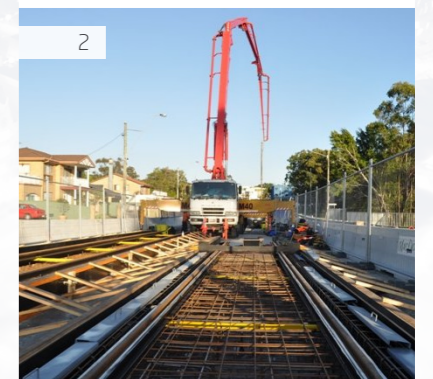
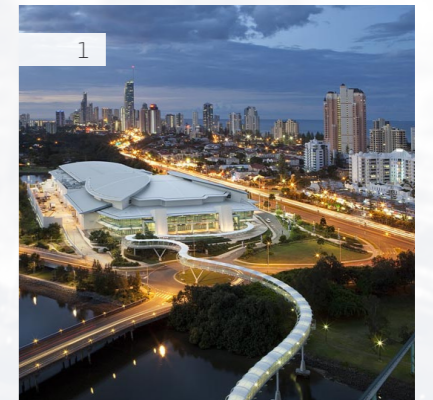
Coupled with this, the savings and cuts in State Government spending will further reduce demand in the civil engineering sector.

The Sunshine Coast construction sector has some welcome relief with building of the new Sunshine Coast University Hospital gearing up.

Activity on the Gold Coast is expected to pick up with major projects such as the light rail under way, the 2018 Commonwealth infrastructure, venues and village proceeding and the cruise terminal and resort back on the drawing boards.

In and around Brisbane, early works have commenced on the Williams Street State Government Building, major retail developers are advancing numerous projects and residential development is increasing.

We expect escalation in tender pricing levels to continue at around 2.0% through to 2014 and trend at around 3.0% in 2015.



Activity on the Gold Coast and in Brisbane is expected to increase with the Gold Coast Light Rail (2) already underway, 1 William Street (3) about to commence construction and works for the 2018 Commonwealth Games (1) currently in planning.

Images courtesy of the Brisbane Convention & Exhibition Centre, GoldLinQ and Queensland Treasury & Trade

WESTERN AUSTRALIA

In **WESTERN AUSTRALIA**, ongoing activity in the mining and resources sector in regional areas will continue to underpin overall construction activity levels within the State. It is however noted that construction workforce numbers in this sector are predicted to peak sometime in 2014 and are then predicted to slowly reduce as the current wave of construction activity associated with minerals and resource production gives way to operational activity.

Whilst overall construction demand in the State is expected to remain at relatively high levels, this slowing of the resource sector will see the total value of construction activity flatten out with levels predicted to remain largely static over the coming 5 to 10 years.

After a number of very poor years we anticipate a return to strong demand in the residential sector, due largely to the effect of demographic pressures coupled with the significant population growth experienced by the State in recent times.

Non-residential construction activity is also predicted to increase steadily in the coming year with many projects now scheduled to commence after the last years' cautious approach from developers' owners towards committing to significant retail and commercial projects.

It is anticipated that increases in construction prices will trend at 2.2% for 2013, rising to 3.0% for 2014 and 3.6% for 2015.

TASMANIA

In **TASMANIA**, the construction market outlook continues to be gloomy with little activity in the residential, commercial, industrial and retail sectors. State Government spending has been significantly reduced and Federal Government stimulus funding has dried up. Housing approvals are continuing to fall with latest records showing a 16% reduction from the previous year. The value of non-residential construction approvals has fallen 35% since last year.

Over the last six months, several contractors, civil engineers, design consultants and suppliers have ceased trading. Tasmanian Timber Engineering, one of Tasmania's biggest building suppliers, has gone into

voluntary administration, citing the downturn in the building industry and Tasmania's biggest building company, Fairbrother, has been forced to lay off staff since Christmas.

The Housing Industry Association said the number of new homes built in Tasmania would drop by 700 this year, to 2,200 the lowest level in more than a decade.

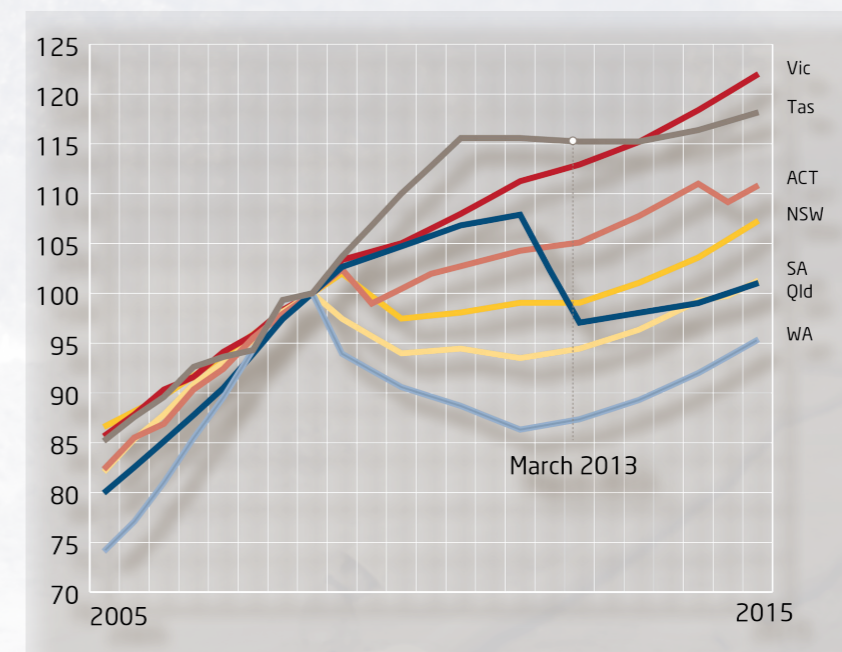
According to the HIA, 'many builders were hugely decreasing their staff pool to compensate for the downturn, with more than 1,900 construction workers leaving the industry in the past year.' The Master Builders Association is also concerned about the decline in the number

of new apprentices employed since the removal of payroll tax exemption for employers.

An ABS Building Activity update showed Tasmanian building activity stabilized towards the end of 2012 and it is hoped that the decline in the industry has been arrested.

We anticipate construction activity to remain subdued throughout 2013 with no tender price escalation followed by increases in the order of 1.0 to 1.5% in the years 2014 and 2015.

Tender Price Escalation Forecasts Regional Market Summary



| | NSW | VIC | QLD | ACT | SA | WA | TAS |
|------|-------|------|-------|-------|--------|-------|-------|
| 2005 | 3.5% | 5.4% | 6.9% | 5.4% | 6.4% | 7.8% | 4.8% |
| 2006 | 4.6% | 4.2% | 5.9% | 6.3% | 6.3% | 12.0% | 5.9% |
| 2007 | 4.6% | 4.5% | 5.5% | 6.0% | 7.6% | 10.9% | 5.1% |
| 2008 | 4.0% | 5.1% | -0.7% | 4.6% | 5.4% | -2.8% | 5.2% |
| 2009 | -4.4% | 1.6% | -3.6% | -1.9% | 2.0% | -5.7% | 4.7% |
| 2010 | 0.6% | 2.8% | 0.5% | 2.3% | 2.0% | -2.1% | 4.1% |
| 2011 | 1.0% | 3.0% | -1.0% | 1.5% | 1.0% | -2.7% | 0.2% |
| 2012 | 0.0% | 1.5% | 1.0% | 0.8% | -10.0% | -1.6% | -2.9% |
| 2013 | 1.5% | 2.0% | 2.0% | 0.8% | 1.0% | 2.2% | 0.0% |
| 2014 | 3.0% | 2.8% | 2.0% | 1.5% | 1.0% | 3.0% | 1.0% |
| 2015 | 3.5% | 3.0% | 3.0% | 3.0% | 2.0% | 3.6% | 1.5% |

The above indices reflect capital city CBD and metropolitan construction costs.

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WT Partnership draws on the collective experience, knowledge and capability of over 1,100 professional staff in locations throughout Australasia, South East Asia, Central America, the United Kingdom and Europe to provide our clients with the right advice on all aspects of cost, value and risk to help them achieve optimum commercial outcomes.

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Note on Applying Tender Price Indices

A number of project specifics should be considered when reviewing tender price escalation forecasts including, but not limited to, the procurement route, size, complexity, location and risk. Equally, the keenness of tenderers is important in terms of pricing and this will be driven by issues such as local market dynamics, workloads, hotspots and realisable margins. With the current uncertainties in the local, national and international arena, it is important to continually monitor the market and review escalation allowances. Clearly, it is very difficult to predict future escalation over the next few years therefore the above advice is offered for guide purposes only at this point.

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