WT PARTNERSHIP

Review of Australian Construction Market Conditions - The True Cost of Construction

September 2012

In our previous commentaries, we warned of the dangers of the two speed economy in relation to engineering construction and the building sector. Our offices continue to see examples of contractors submitting very aggressive tenders to maintain some level of turnover. The fallout from the recent demise of several large contractors is spreading as a number of subcontractors and suppliers face significant loss. Preceding recent collapses, in the FY 2010/2011 almost 2,000 construction firms across Australia went into insolvency. Our earlier commentaries foreshadowed potential bleak times for the industry and the true cost of construction is becoming painfully apparent.

Outside of engineering construction, the industry continues to suffer the effects of the continuing GFC and the building sector remains entrenched in negative territory in a number of states. Compounding the reduced demands from the private sector and all levels of government adopting a recovery mode to redress major budget deficits the industry has also started to experience industrial unrest. However, engineering construction, whilst declining from record levels of activity, continues to benefit from mining and resources infrastructure development.

Despite worsening conditions, there is an air of cautious optimism that the economy is turning the corner with the accompanying expectation that the nation's building sector will recover over coming years. Whilst the media reports doom and gloom and the 'end of the mining boom', statistics show that there is no immediate end to the boom in sight. In WA alone, engineering construction work increased 50% over the preceding year, has trebled over the last seven years and is forecast to continue to grow at high levels.

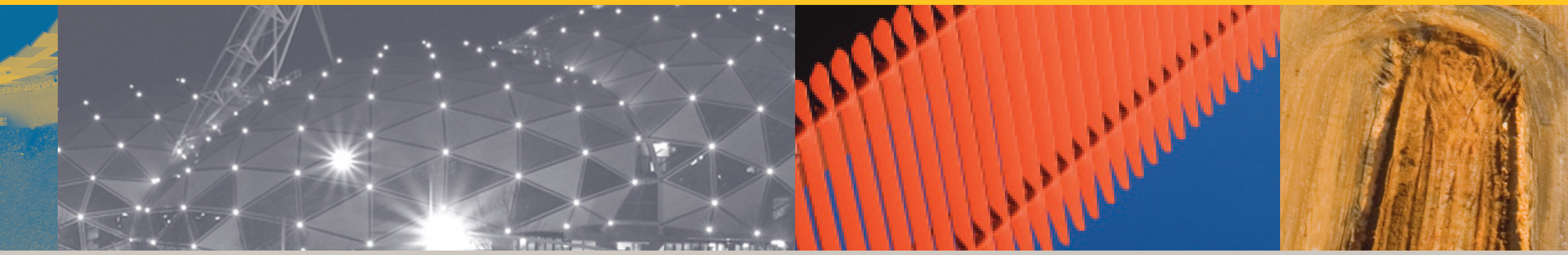
Infrastructure construction across the country remains buoyant with the North West Rail Link still a topic of much conversation in NSW, the early work package having been let and the tunneling package is due out this month.

Although the continuity of project start ups has slackened off, many civil contractors are busy tendering to such an extent that we may see further uplifts in margin on tender prices in the new year.

Mining remains a cornerstone of the resource sector for the Hunter region, Central Queensland and across WA however falling coal prices are having a similar effect on project viability as slumping iron ore prices. Many projects across Australia have either been placed on hold or are slowing dramatically. This has had an immediate effect on contractors and consultants with resultant downsizing in staff. State Governments, particularly in SA, are re-thinking capital works programmes due to lack of forecast income from mining taxes/royalties.

Overall, each State is aware of the need for major investment in transport infrastructure, the ever increasing cost of maintaining the current assets and the need for revenue. New ways of financing major road and rail projects are being mooted and major transport infrastructure looks destined to become a user pays system.

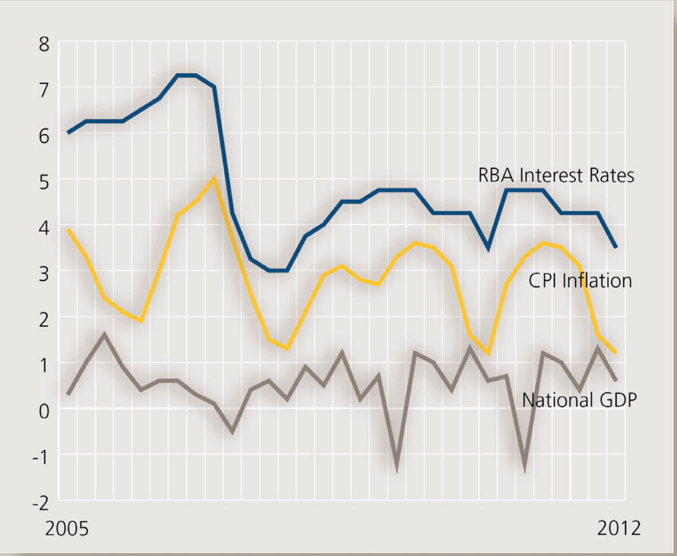
We are experiencing a cautious optimism amongst our major clients with various building projects finally progressing beyond development approval into tender and construction. BIS Shrapnel recently forecast that the decline in mining activity will be countered with increases in non mining investment and has singled out property, building and construction as a key growth area. On a brighter note therefore, it is possible that we can look forward to increased activity in building construction and development in the future.



National Economic Indicators

- GDP expanded 1.3 % from the December 2011 quarter through to the March 2012 quarter and 0.6% from the March 2012 quarter through to the June 2012 quarter.
- CPI rose 1.6% over the quarter ending in the March 2012 and 1.2% over the year ending in June 2012. These compare with a rise of 3.1% through the year ending in the September 2011 quarter. The last four quarterly data sets for CPI inflation, released by the RBA, have been lower than the CPI inflation rate preceding it, suggesting a downward trend.
- The Australian dollar (AUD) has continued to trend sideways, remaining around parity with the US Dollar (USD) since January 2011. The AUD was trading at approximately $1.035 as at the end of August 2012.
- The seasonally adjusted Australian unemployment rate has remained stable since our previous report. The rate has ranged between 4.9% and 5.2% and is currently 5.1% according to ABS August data.
- The RBA reduced the official cash rate by a total of 75 basis points with a 50 basis point reduction in May and a 25 basis point reduction in June 2012. The RBA's current Target Cash Rate is 3.50%.

AUSTRALIAN ECONOMIC INDICATORS



National GDP measure: seasonally adjusted quarterly % change

Source: RBA; ABS; Quarterly trend review on GDP, CPI inflation, RBA cash rate.

"Our offices continue to see examples of contractors submitting very aggressive tenders to maintain some level of turnover." Craig McHardy (Brisbane)

National Construction Indicators

ABS seasonally adjusted estimate for **'total construction work done'** increased by 7.0% in the March 2012 quarter and a further 1.1% in the June 2012 quarter to a total of $48,833,600,000. The consecutive increases during the March 2012 and June 2012 quarters follows a 4.6% fall in the December 2011 quarter which was the largest percentage fall since the March 2000 quarter. The total construction work done for the twelve month period between the June 2011 quarter and the June 2012 quarter has increased by 14.9%.

The seasonally adjusted quarterly estimate for **'building work done'** decreased by 2.1% in the March 2012 quarter. This fall preceded a rise of 0.4% in the June 2012 quarter. The total building work done for the twelve month period between the June 2011 quarter and the June 2012 quarter has decreased by 2.8%.

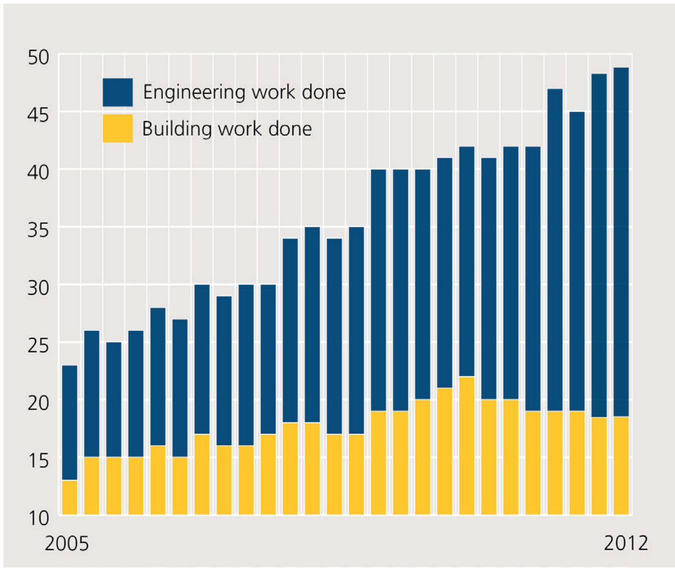
The seasonally adjusted quarterly estimate for **'engineering work done'** increased by 13.6% in the March 2012 quarter and a further 1.56% in the June 2012 quarter to a total of $30,315,100,000. This increase follows a 6.3% decrease during the December 2011 quarter. The seasonally adjusted yearly estimate for engineering construction work carried out in Australia has risen by 29.4% over the 12 month period between the June 2011 and the June 2012 quarter.

Of the ABS's seasonally adjusted estimate for **'total construction work done'** in the amount of $48,833,600,000, **'building work done'** represents 38% of total construction work done while engineering work done represents 62% of total construction work done. Engineering work done as a percentage of total construction work done has continued to increase since the December 2010 quarter.

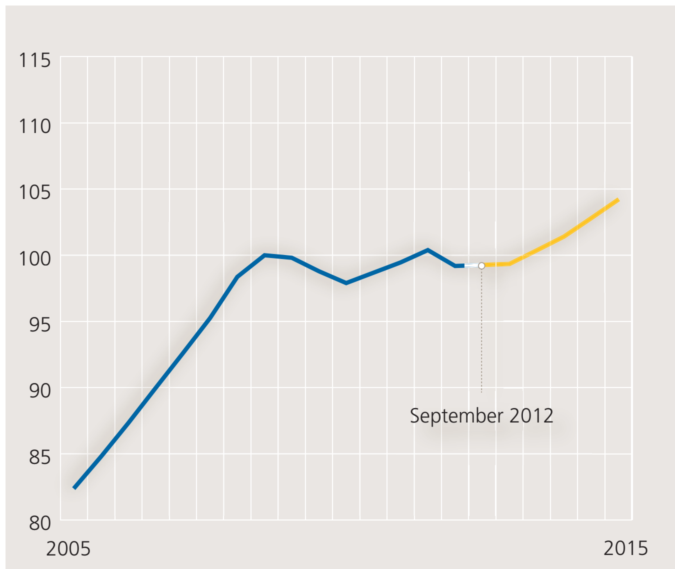
"The cancellation of Olympic Dam has rocked the State's confidence in a way that has not been seen since the collapse of the State Bank in 1991"

Sam Paddick (Adelaide)

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 Commentary

From a **New South Wales** perspective, our ***Review of Australian Construction Market Conditions*** released in March predicted a 2% increase in 2012 followed by a 4% increase in 2013, the latter increase reflecting a 'catch up' in tender prices and acknowledging the 5% per annum EBA increases. It is clear that the lack of project starts to date and likely further delays to commencements which is anticipated to continue until at least the first quarter of the New Year has kept downward pressure on tender pricing levels. This combined with several second tier builders and major subcontractors such as the Hastie Group going out of business in the last year has also created a very nervous development environment. Accordingly we have re-assessed our projections and believe 2012 will show cost escalation of 0%, 2013 an average of 2% and 2014 an average of 2.5%.

In **Victoria,** the tender market continues to return competitive results. The volume of new work is below market capacity and contractors are consistently canvassing for new opportunities. We are experiencing wide ranges in tender returns of up to 15% from short-listed, established contractors suggesting continued increases in material and labour costs are being countered by discounted head-contractor and trade margins.

The Property Council of Australia advises commercial vacancy rates in the Melbourne CBD increased from 5.2% to 5.6% in the first half of 2012. Anchor tenant pre-commitment thresholds continue to create a challenge to securing funding and have resulted in the deferment of some new commercial spaces.

There has been an increase in the number of retail-related project enquiries in the new financial year. Improvement works as well as new build opportunities are once again the focus of experienced retailers. The Infrastructure sector continues to be buoyant particularly with the construction of ports, rail and aviation. Activity continues to be sluggish in the multi unit residential sector with the downturn in presales.

Notwithstanding the instances of margin discounting and high sub-contractor competition noted in tender returns in the last quarter, we forecast tender price escalation to be marginal to the end of this year, in the range of 1.5 – 2.5% per annum through 2013 and increasing to 2.5 – 3% in 2014.

The **Queensland** industry continues to reflect our 'two speed economy' with hot spots in regional areas driven by demands from the mining and infrastructure sectors in stark contrast to the sluggish conditions in the Brisbane, Gold Coast and Sunshine Coast regions. As we expected (and previously commented upon), the real cost of builders buying work is now being seen with further casualties this year added to the fallout from the GFC experienced in 2009/10.

The new State Government is reeling from the inheritance of a $10 billion deficit and has taken on the Federal Government and the resources sector over mining royalties in an attempt to increase revenue. Forecasts show that the State's economy is expected to grow bolstered by LNG construction and continued development in the resource sector.

Tendering in sectors other than civil engineering and infrastructure, remains extremely competitive and we anticipate that tender escalation in the South East of the state of around 1.5% for 2012 rising to 2% through 2013.

The tender market in **South Australia** has seen an extraordinary drop in pricing levels over the past six months, with discounts of up to 20% noticeable against benchmarked pricing. The point at which the market might 'rebound' and the extent of such is the source of much speculation. In the event of the collapse of major builders, the market correction could be dramatic.

Major clients are expressing grave concerns about the stability of the construction market and the long term viability of building companies winning projects at cut throat levels. The collapse in July of the ADCIV Group, one the State's largest civil engineering contractors, emphasises instability in the market.

Construction remains dominated by a small number of very large projects with little in the pipeline to offer contractors.

The State Government has largely committed its available resources during this financial year and is unlikely to commit to any major procurement for at least another 12 months. Compounding this, the decision by BHP Billiton (BHPB) to cancel the expansion of Olympic Dam impacts on state revenue and further reduces construction demand.

The cancellation of Olympic Dam has rocked the State's confidence in a way that has not been seen since the collapse of the State Bank in 1991. It remains to be seen how this lost confidence translates to the construction market but within one week of BHPB's announcement, construction companies in the regional towns of Whyalla and Port Augusta were closing down.

Given the volatility in the prevailing market, predicting escalation is very difficult however, it is likely that the sudden drop in tendering levels recently experienced will be corrected over the next few years. We are predicting escalation to trend at -10% for 2012 and then at levels of 1% to 2% pa for the years 2013 and 2014.

The **Western Australia** construction market continues to be the most marked example of the phenomenon of a 'two speed economy' seen throughout Australia.

Despite recent announcements of a delay or deferral of a number of major resources infrastructure projects including BHPB's outer harbour development at Port Hedland, the State continues to see record levels of activity in the engineering construction sector. Even with the more cautious positions being taken by the large miners, due to the recent dip in iron ore prices, sector analysts see no immediate end to these high levels of construction activity with unprecedented levels of committed construction work still in the pipeline.

Outside of engineering construction, whilst activity in many market sectors remains sluggish, the overall view of the States prospects continues to be one of cautious optimism. Whilst significant additional office space has come on the market with the recent completion of Brookfield Multiplex's City Square development and the troubled Raine Square development, Perth CBD continues to have the lowest office vacancy rate of all the major capital cities. This opportunity sees a number of significant office developments currently in the design pipeline. State Government spending on capital infrastructure continues to be strong although tender pricing for this work remains extremely competitive. Retail development is also showing a cautious return with at least one major regional shopping centre redevelopment set to commence prior to the end of the year. The outlook is perhaps bleakest for residential construction with the HIA reporting that activity in this sector in 2011/2012 was at the lowest level on record for the past eight years.

Based on the market expectations outlined above it is anticipated that increases in construction prices will trend at 2.9% for 2013 rising to 3.6% for 2014.

The immediate future for the **ACT** hinges on the upcoming State Government election. As the Government goes into 'caretaker' mode, projects not already approved have been placed on standby.

With the prospects of staff cuts by both the current and future Federal Government as part of its efficiency / austerity measures, the current conditions are not conducive to large investment projects which are now being shelved or deferred. With the exceptions of the continuing redevelopment of the Canberra Hospital and various infrastructure works, there are no notable new Government projects.

Building approvals are in decline with developments delayed due to the lack of tenants or difficulty in obtaining finance.

The construction market remains fiercely competitive with builders continuing to cut costs in order to survive. Instability in the construction workforce is now more apparent due to inconsistent tendering prospects.

It is anticipated that tenders will continue to be keenly priced for the remainder of 2012 and into 2013 and our forecast is that cost escalation will trend at less than 1% for the current year rising to 2.5% and 3% for 2013 and 2014 respectively.

The construction market in **Tasmania** continues to soften with significant reduction in state government spending.

Housing approvals continue to fall and anticipated large projects such as Royal Hobart Hospital Redevelopment, Parliament Square and other CBD office building developments are yet to come on stream.

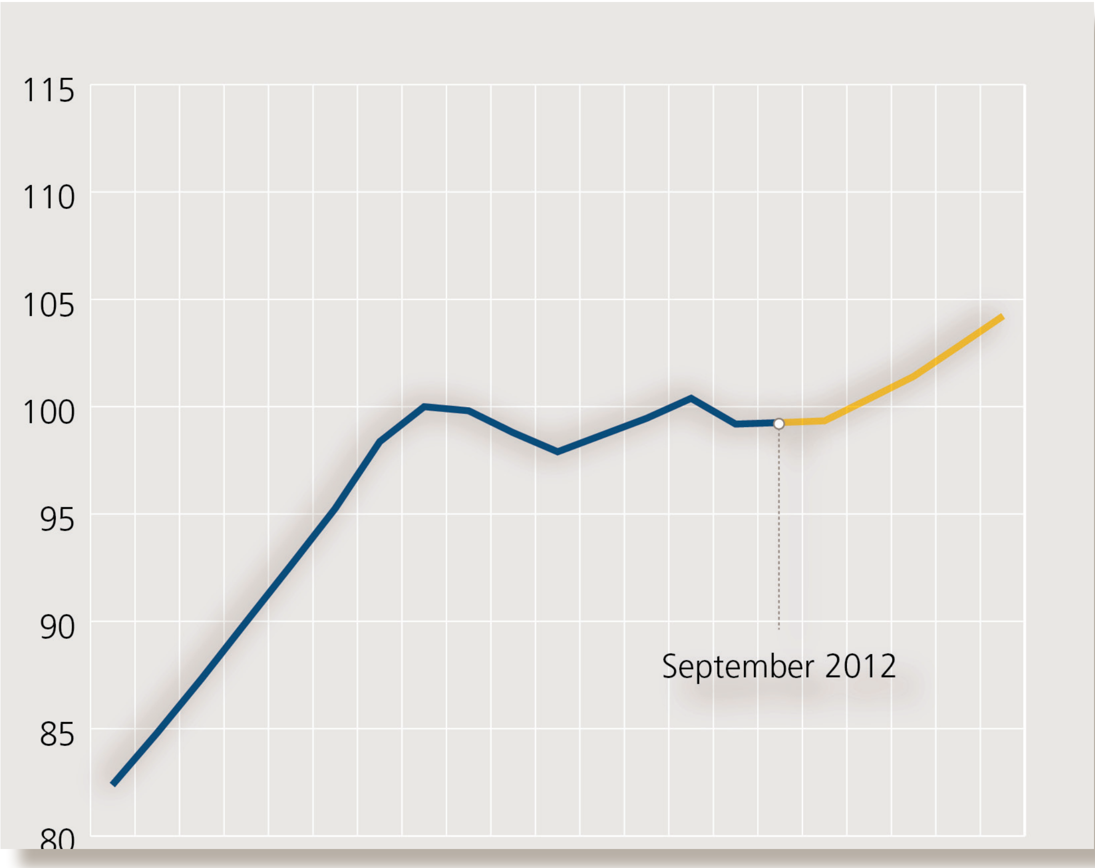
When these projects commence we could see elevated tender pricing, however the recent influx of mainland builders pursuing large projects may counter this.

Tenders are extremely competitive with minimal (if not negative) margins tendered in order to maintain turnover and preserve workforce.

Various contractors, engineers, architects and suppliers have ceased trading.

We anticipate continuing contraction throughout the first half of 2013 and then stabilizing with escalation trending around 2.5 - 3% in the years 2013 and 2014.

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%	9.3%	5.1%
2006	4.6%	4.2%	5.9%	6.3%	6.3%	10.5%	4.5%
2007	4.6%	4.5%	5.5%	6.0%	7.6%	10.9%	6.1%
2008	4.0%	5.1%	-0.7%	4.6%	5.4%	-5.4%	4.4%
2009	-4.4%	1.6%	-3.6%	-1.9%	2.0%	-3.6%	6.1%
2010	0.6%	2.8%	0.5%	2.3%	2.0%	-2.1%	5.1%
2011	1.0%	3.0%	-1.0%	1.5%	1.0%	-2.7%	0.0%
2012	0.0%	1.5%	1.0%	0.8%	-10.0%	1.2%	-0.3%
2013	2.0%	2.0%	2.0%	2.5%	1.0%	2.9%	0.0%
2014	2.5%	2.5%	3.0%	3.0%	2.0%	3.6%	1.0%

The above percentages include allowances for the Carbon Price Mechanism however this may need adjustment once the full effect of the legislation is determined by the industry.

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WT Partnership draws on the collective experience, knowledge and capability of over 1,000 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. Clearly, it is very difficult to predict future escalation over the next few years given the current state of the international markets and potential impact of the Carbon Tax however, the above advice is offered for guide purposes only at this point. With the current uncertainties in the local, national and international arena, it is important to continually monitor the market and review escalation allowances.