WT PARTNERSHIP

# Review of Australian Construction Market Conditions - A Tale of Two Economies

## March 2012

Australia's resources sector, driven by Asia's demand for West Australian iron ore and Queensland coal, has created over 44,000 new full time jobs in the North East - which contrasts with the South Eastern states which sacrificed 38,000 full time jobs in the same period.

This growth is feeding major mining and infrastructure projects with the ABS reporting an estimated increase of almost 50% in the value of engineering construction projects undertaken between September 2010 and September 2011. Subsequently the most recent information released by the ABS shows that engineering construction work decreased by 5% during the December 2011 quarter.

The resources boom however has failed to translate into an increase in building construction in the South East of the Country. Private sector construction development is lagging forecasts due largely to availability and cost of finance and the ABS data showed building work, during 2011, reduced by some 10%.

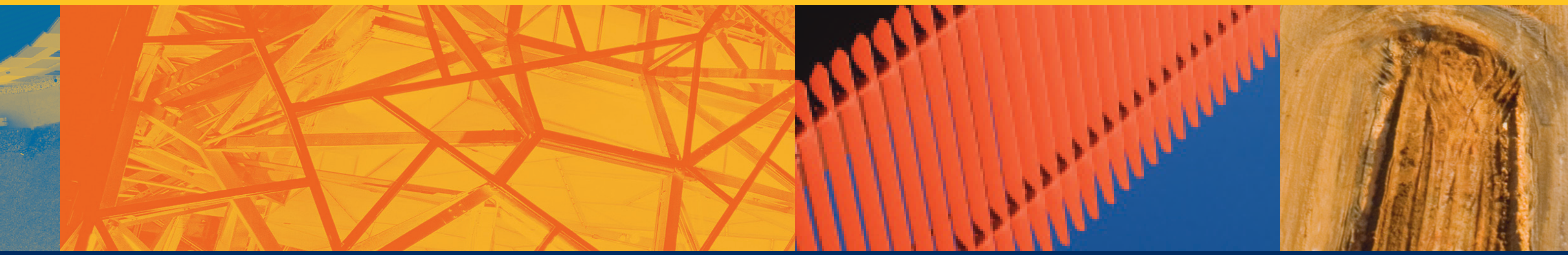
Despite this most commentators are relatively optimistic. It is anticipated that South East Australia will begin to benefit from the resources boom and private sector development and construction activity will improve during 2012 as demand for commercial space and housing increases.

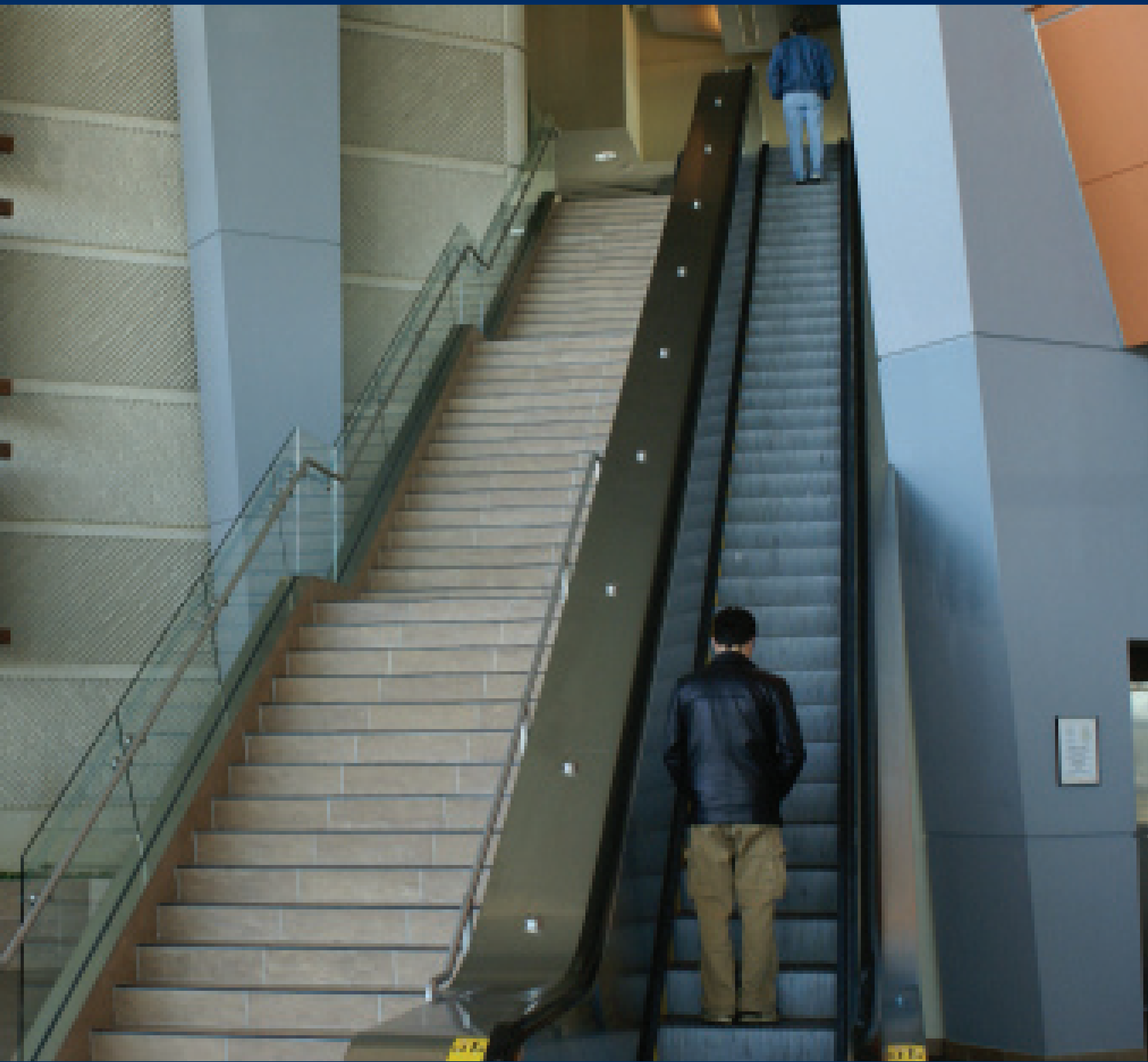
Countering this, borrowers hoping to enjoy lower interest rates following the reductions implemented by the RBA are having their hopes quashed with banks pleading increased costs resulting from their exposure to international markets.

Material costs continue to rise much in line with inflation but competitive tender conditions in the non-engineering sector are countering construction cost increases. Some of our offices are seeing tenders at levels where margins are discounted to nil and even subcontract prices are discounted by main contractors in the expectation that subcontractors will become increasingly desperate to fill their order books.

Whilst cost escalation in engineering and mining is expected to continue at relatively high levels, the general view of returning confidence in private development will take some time to flow over to the construction market which will we believe continue to absorb demand within its excess capacity for at least the current year.

The introduction of the Carbon Price Mechanism from 1 July of this year will have an inflationary effect on all sectors (refer our comments later in this Review) and has added further uncertainty in cost escalation in future years.



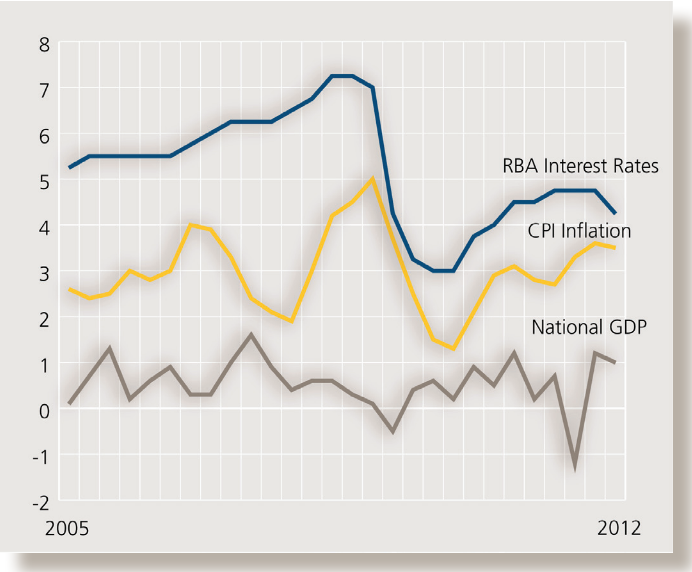


*The construction market continues to reflect Australia's two speed economy and the impact of demands generated by the resources boom on the non-engineering construction sector is yet to be realized.* Craig McHardy (Brisbane)

# National Economic Indicators

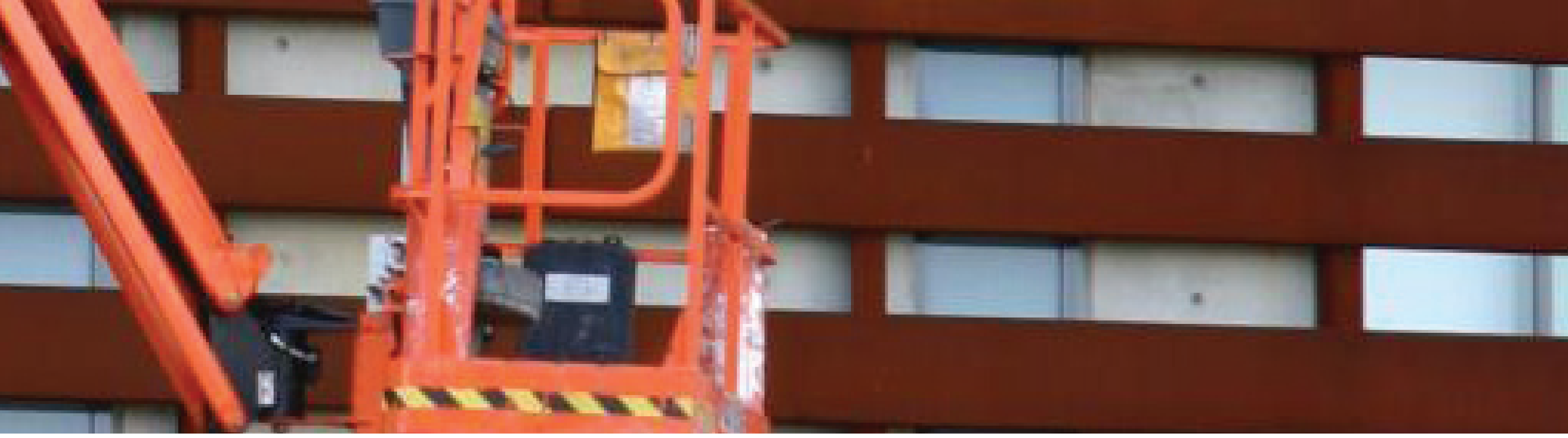
- Gross Domestic Product expanded 0.4% from the September 2011 quarter through to the December 2011 quarter.
- Australia's Consumer Price Index rose 3.1% over the year ending in the December 2011 quarter, compared with a rise of 3.5% through the year ending in the September 2011 quarter.
- The Australian dollar has trade around parity in recent months and has since risen to be trading at approximately $1.07 US Dollars as at February 2012. The Australian dollar appreciated after the RBA recently surprised the market and decided to hold interest rates as opposed to easing.
- The seasonally adjusted Australian unemployment rate has decreased slightly to 5.1% in January 2012 from 5.2% in December 2011.
- The RBA reduced the official cash rate by a total of 50 basis points in November and December 2011 to 4.25%. The RBA's current Cash Rate Target remains at 4.25%.

## AUSTRALIAN ECONOMIC INDICATORS




National GDP measure: seasonally adjusted quarterly % change

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



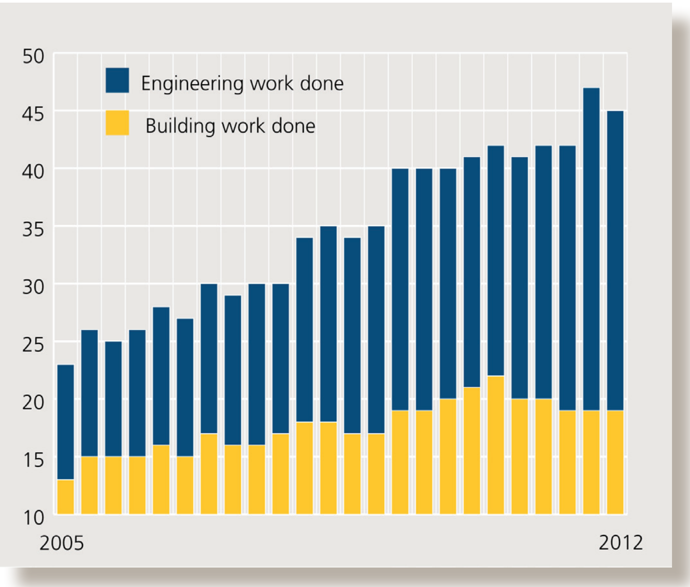
# National Construction Indicators

The ABS's seasonally adjusted estimate for 'total construction work done' has decreased by 4.6% to $45.1 billion in the December 2011 quarter, falling for the first time since the September 2010 quarter. The December fall follows a 12.5% rise in the September 2011 quarter which was the largest percentage rise in the last 10 years. Despite the recent December 2011 quarterly fall, the total construction work done for the twelve month period between the December 2010 quarter and the December 2011 quarter has increased by 9.2%.

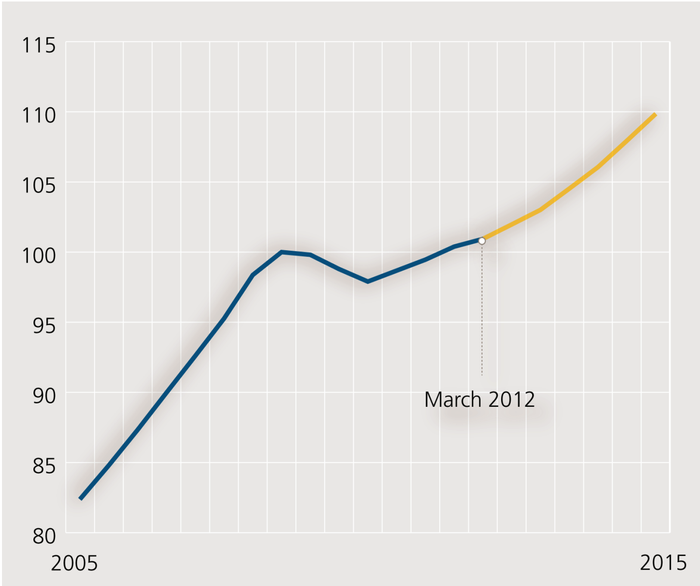
The seasonally adjusted quarterly estimate for 'building work done' decreased by 4.0% in the December 2011 quarter. This fall follows a rise of 0.6% in the September 2011 quarter and two consecutive declines of 3.4% and 4.9% in the 2011 March and June quarters. The seasonally adjusted estimates for 'building work done' for the year ending December 2011 decreased by 8.6%.

The seasonally adjusted quarterly estimate for 'engineering work done' decreased by 4.0% during the December 2011 quarter. This decrease follows a 22.6% rise during the September 2011 quarter and a 5.9% rise during the June 2011 quarter. The seasonally adjusted yearly estimate for engineering construction work carried out in Australia has risen by 48.9% over the 12 month period between the September 2010 and the September 2011 quarter. This has fallen to 27.1% between the December 2010 quarter and the December 2011 quarter.

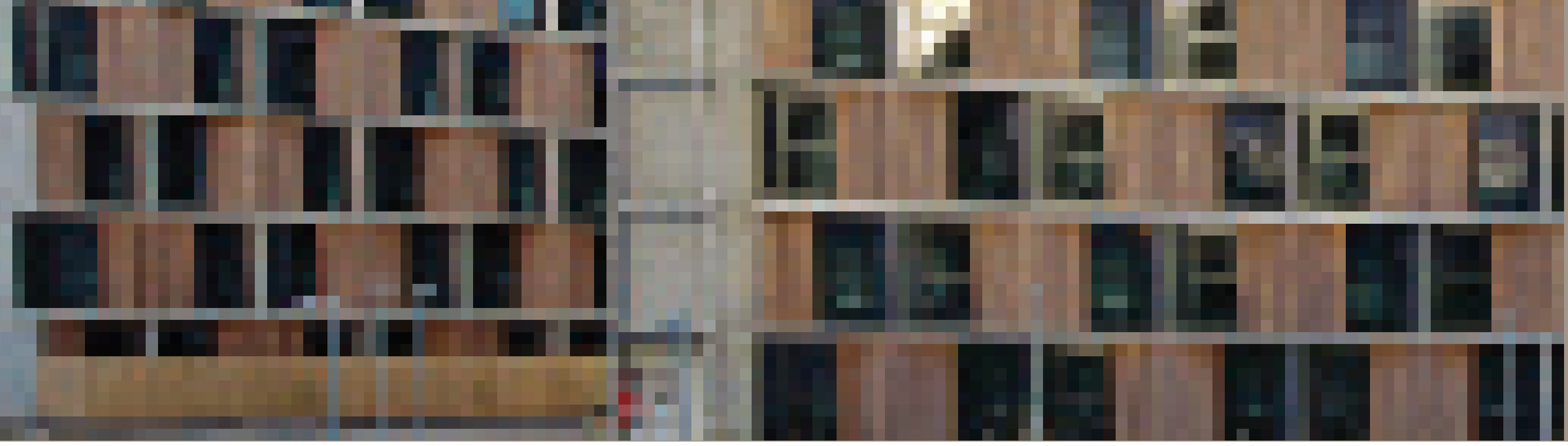
## VALUE OF CONSTRUCTION WORK DONE IN AUSTRALIA ($ BILLION)




## 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).



# New South Wales

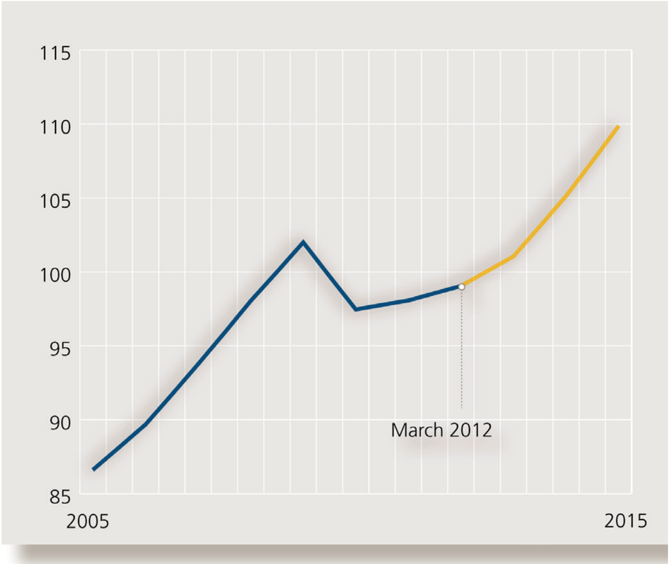
National confidence in the construction industry has always been sensitive to the effects of international markets, Sydney more so than any other Australian city. Therefore the resolution of the European credit crisis together with an improving US economy will have a major effect on whether the recent improvements in the NSW market is maintained.

The Coalition Government, since returning to power in March 2011, has amended the State Planning Act relating to (Part 3A) approvals for major projects and marginally increased infrastructure expenditure; but as a whole, has been slow to instigate real changes in policy, legislation and government spending to produce any real beneficial effects on the NSW construction industry.

Despite this the NSW construction industry has continued to slowly improve throughout 2011, and as we enter the end of the first quarter of 2012 there are signs of emerging confidence in the local economy and property sector, with bank lending for construction projects and leasing activity increasing.

However, second tier contractors are struggling to replace the work load which emanated from the BER programme creating fiercely competitive tendering environment for mid-scale projects. We do anticipate an up-swing in late 2012 which is likely to result in a steady increase in tender pricing levels. Construction cost escalation is forecasted to increase by approximately 3.0% by the end of 2012.

**TENDER PRICE ESCALATION - NEW SOUTH WALES**




*The Coalition Government... has been slow to instigate real changes in policy, legislation and government spending to produce any real beneficial effects on the NSW construction industry.*

Phil Anseline (Sydney)

# Victoria

The tender market in Victoria is competitive relative to construction capacity and as a consequence we are experiencing tender price discounting generally across all sectors, particularly at the mid tier level.

Expiration of stimulus packages together with capital works budget constraints at Federal, State and Local government levels is weakening confidence in the extent of public sector projects.

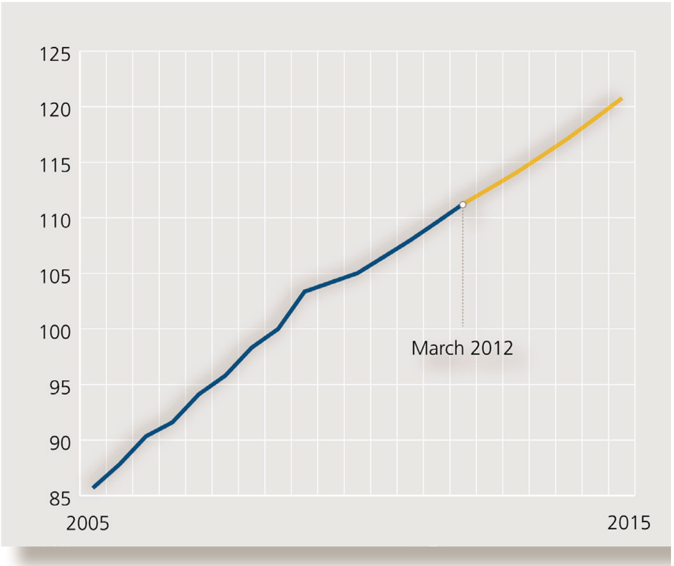
There has however been a reasonable amount of activity in the private and institutional sectors, predominantly in multi-storey residential and commercial buildings as well as retail developments. In addition there are a number of mid-range higher education projects in the planning and design phases while the VCCC hospital project is about to begin the construction phase.

Capital works programmes in the ports, aviation and rail sectors will provide a volume of work in the future while predicted increases in the CBD and city fringe rentals will drive further development in the commercial sector.

While the number of construction projects coming to tender has been moderate in the first quarter of 2012 we expect the number to increase in the third and fourth quarters.

We forecast tender pricing escalation to be in the range of 2.50-2.75% per annum through 2012 and 2013 increasing to 3.00-3.25% by 2014.

**TENDER PRICE ESCALATION - VICTORIA**



*‘ extreme competition lends itself to a situation where the winning tender may often be the tender that missed something and is therefore unsustainable in the longer term ’*

Tony Brewster (Adelaide)

## South Australia

In our Market Report of September 2011 we forecast that the industry uncertainty that was creating a flat market and competitive tendering conditions were likely to prevail until procurement of such projects as the New Royal Adelaide Hospital and Adelaide Oval. It now looks likely that this flat market will continue beyond procurement of those large projects. Whilst the Government agencies are continuing to procure facilities such as hospital extensions, GP super clinics and schools, the continued lack of commercial construction activity is sustaining a depressed tendering market.

Local contractors have successfully lobbied the State Government to keep the open tendering situation in place with the result that during 2011 it was not unusual to see up to 20 competitive tenders on small to medium sized projects. This aggressive competition will inevitable lead to disputes and risk of company failures.

There are a number of commercial projects in feasibility stage, including many retail developments, however the combination of tight construction finance requirements and reduced developer margins are limiting factors on whether projects get of the ground or not.

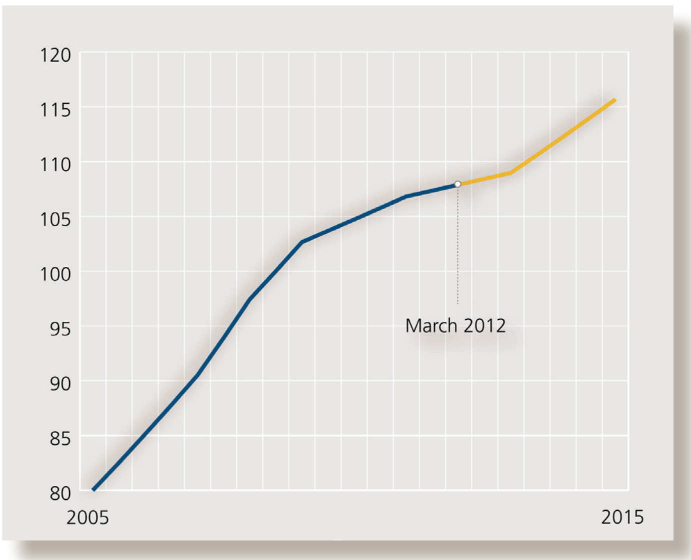
The infrastructure sector is faring slightly better with major large volume transit road projects both south and north of the CBD and the planning continuing for infrastructure to facilitate the BHP Olympic Dam expansion. However there are concerns that much of the infrastructure works will utilize interstate contractors and might do little to stimulate the local general contracting market.

In the event, 2011 proved to be a year of minimal escalation overall. Some individual tender results might have suggested negative escalation values but we consider this was merely localised final corrections following the completion of the BER works.

Locally the transition to a new State Premier has now concluded and there will be a period of reflection and pause whilst the new administration settles in. We consider that the competition in the South Australian market will mean that regardless of EBAs, material price rises and exchange rate fluctuations, there will be negligible escalation in the first half of 2012. Thereafter we see the market recovering slowly with around 0.5% to 1% escalation during the second half of the year.

Beyond the end of 2012 will depend upon how Europe resolves it’s problems, but a conservative approach would be to assume moderate escalation in the order of 3 to 4% per annum for the foreseeable future.

**TENDER PRICE ESCALATION - SOUTH AUSTRALIA**



# Queensland

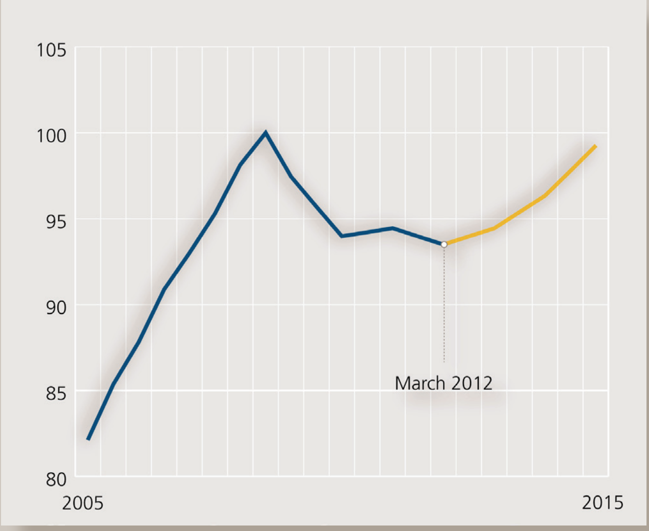
Construction market conditions in South East Queensland remained flat throughout 2011. As we predicted in our September report, the impact of the floods on construction cost escalation turned out to be negligible and we are only now seeing some impact driven by the repairs and reinstatement to State infrastructure. Building repairs have easily been accommodated by the excess capacity resulting from the fallout post GFC. The Brisbane market started to responded to demands from the resources sector with commercial fitout work and apartment developments showing signs of resurgence but, with little private investment in new development, many contractors continued to struggle. In its Property Industry Confidence Survey, the PCA found that 'the industry is still to be convinced that record investment by the mining sector in Queensland will flow to a broader economic recovery'.

The Gold and Sunshine Coasts remained particularly flat throughout the year. Some welcome news for Gold Coast developers came with the Gold Coast City Council's announcement that development charges will be abolished. This is in the hope that hundreds of projects lying dormant may now become more feasible helping to revive the local construction market.

With the Federal Reserve reducing rates as we enter 2012, it is anticipated that (provided the Banks follow suit) demand will grow as private developers and investors start to capitalize on the demands generated by the resources boom. The extent of resurgence in demand on construction is of course dependent on the Banks' appetite for lending which is dependent on their exposure to the Euro crisis. With State Government and Brisbane City Council focused on elections in March and April respectively, momentum has slowed on public mooted projects.

Queensland remains a two-speed economy with little evidence of the resources boom impacting on construction costs (other than in some regional hot-spots). Our predictions are that construction cost escalation (in the SE corner) will, later this year begin to react to the demands generated by the resources sector and, compounded with rising material and labour costs and the impact of the so called Carbon Tax will trend towards 1.5% at the end of 2012 rising to 2% and 3% in 2013 and 2014 respectively.

**TENDER PRICE ESCALATION - QUEENSLAND**



*The demands of large engineering projects in remote locations are expected to continue to draw greater numbers of skilled works away from the already finite pool of labour available in the State.*

Tom Connor (Perth)

## Western Australia

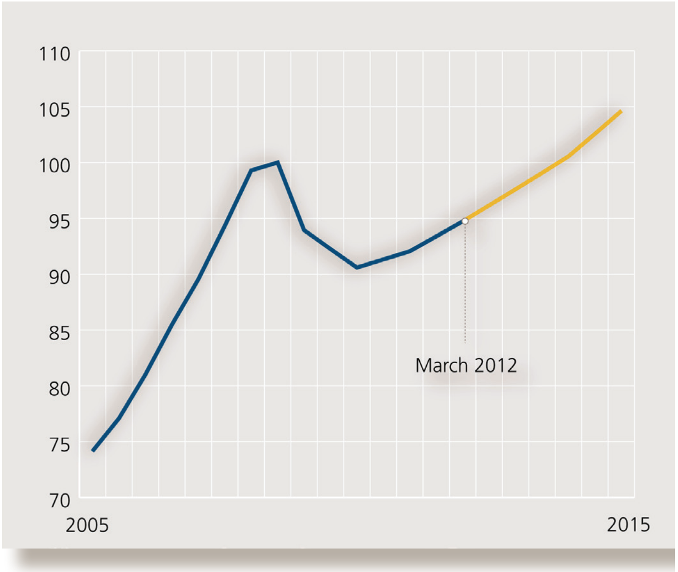
Western Australia's construction industry, and the larger State economy, continues to be underpinned by the current minerals and resources boom. Proposed major expansions of existing mining, oil and gas infrastructure facilities and construction of new facilities will see large volumes of engineering construction work being undertaken with the Australian Construction Industry Forum, predicting that engineering construction in WA is expected to rise to record levels in coming years.

The confidence in the State's overall financial position has also seen the State Government embark on an ambitious capital works programme, with a series of major infrastructure facilities scheduled for delivery in the coming years.

The boom has however, seen the development of a deepening sectorial divide in activity with the two speed economy being particularly noticeable in the residential, retail and commercial construction markets, which continue to be reasonably static.

Based on the anticipated increasing volume of engineering construction activity and the perennial problems of lack of depth and resource in the WA construction market, it is anticipated that construction prices will show an appreciable level of escalation during the coming years, predicted to trend at 3% for 2012 and 2013, rising to 4% in 2014.

**TENDER PRICE ESCALATION - WESTERN AUSTRALIA**



## Tasmania

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

Anticipated large projects like 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 tenders however the recent influx of mainland builders for large projects may limit the effect.

We anticipate marginal contraction throughout the first half of 2012 but stabilizing later to see a modest increase in costs later in 2012/2013.

## ACT

With declining prospects in most property sectors, particularly commercial property, levels of construction in Canberra have eased with current tenders being enthusiastically priced.

Continuing high office vacancy rates will mean contraction of office construction over the short term.

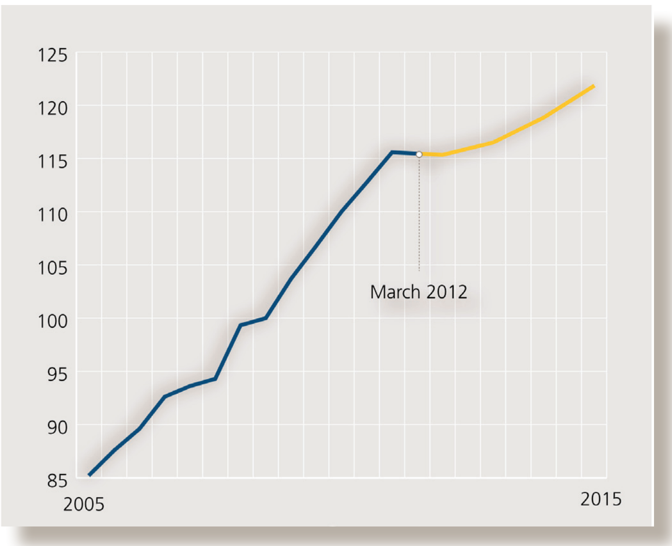
Residential construction is slowing with building approvals falling to 30% over the past year.

New retail developments remain thin on the ground.

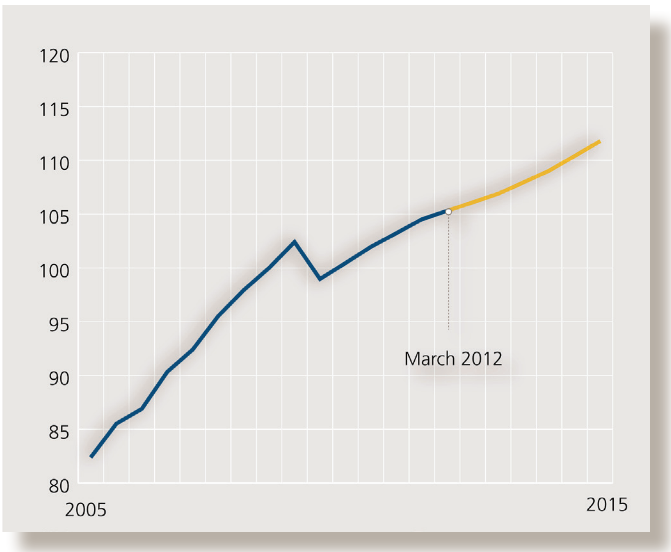
With the ACT Government's continuing redevelopment of the Canberra Hospital and construction of new community health centres for the Territory's suburbs, this area of the market remains busy for the foreseeable future.

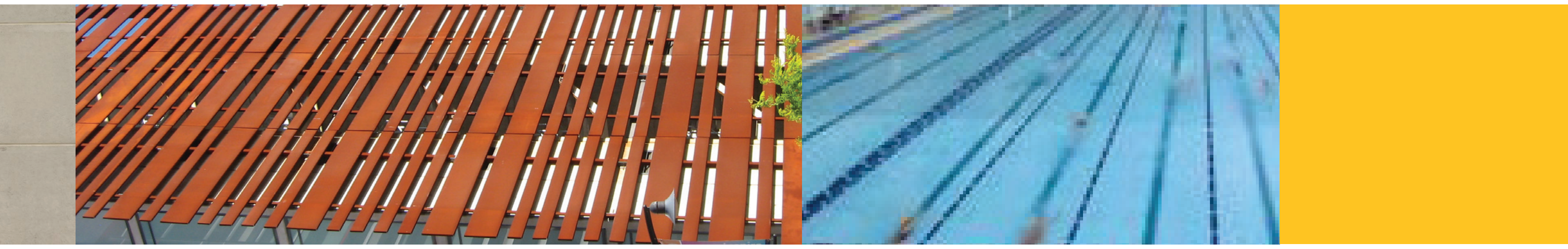
It is anticipated that tender prices will continue to be keenly priced for 2012, with a forecast for cost escalation expected to be at 1-2% for the year.

**TENDER PRICE ESCALATION - TASMANIA**

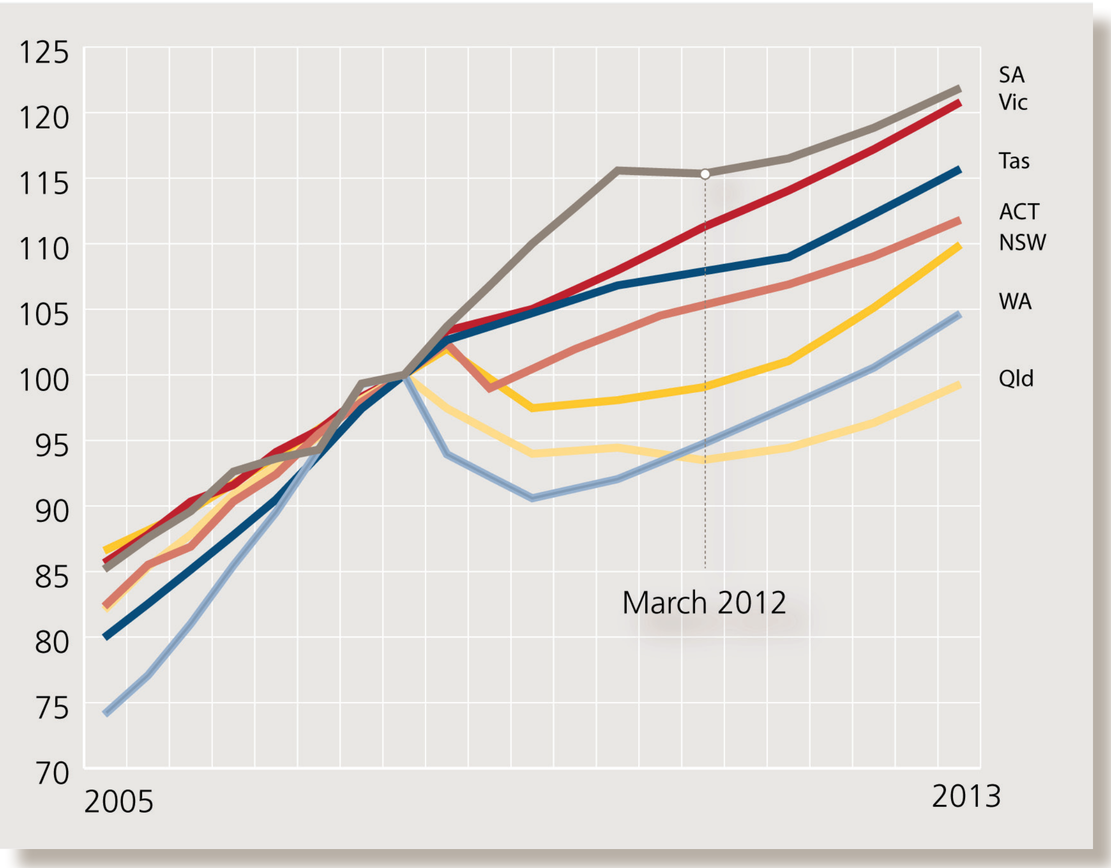



**TENDER PRICE ESCALATION - ACT**



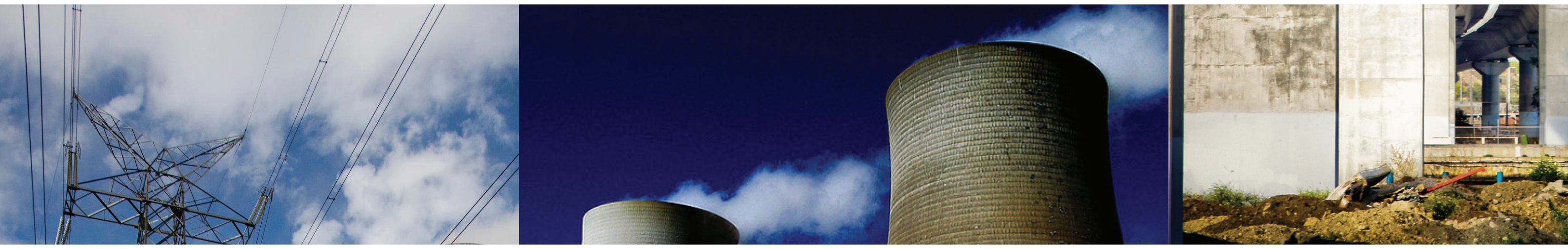


# Tender Price Escalation Forecasts
# Regional Market Summary




| | 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% | 2.8% | 2.0% | 1.6% | 5.1% |
| 2011 | 1.0% | 3.0% | -1.0% | 2.0% | 1.0% | 2.9% | -0.2% |
| 2012 | 2.0% | 2.5% | 1.0% | 1.5% | 1.0% | 3.0% | 1.0% |
| 2013 | 4.0% | 2.8% | 2.0% | 2.0% | 3.0% | 3.0% | 2.0% |
| 2014 | 4.5% | 3.0% | 3.0% | 2.5% | 3.0% | 4.0% | 2.5% |

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.



## The Carbon Price Mechanism (CPM)

The impact of the CPM on construction costs has been widely reported with commentators predicting increases of 0.5% to an upper limit of 1.7%.

Whilst we agree that prices will increase in the first year, the possible increases in subsequent years is more difficult to calculate. Although the price of carbon is fixed for the initial three year period with fixed increases of 5% per annum, manufacturers will likely adopt more sustainable processes, potentially reducing or mitigating the ongoing increases.

The Federal Government's assistance package for Emission Intensive Trade Exposed (EITE) industries seeks to minimise the impact of the CPM on emissions heavy industries, namely steel, aluminium, lime and cement clinker manufacturers, to ensure that production remains internationally competitive. The level of 'pass through' from these industries is unknown making the estimated cost increase to the consumer difficult to calculate.

Should the full 94.5% assistance (relief or shielding) be passed on, the impact on material costs from these industries, as a result of the CPM will be negligible. However, should these industries chose to withhold some or all of the assistance the increases will be significantly different.

Calculations undertaken by WT Partnership's sustainability consultancy practice, WT Sustainability, on manufacturing and material processing indicate a nett trade cost increase between 0.4% and 0.7% dependant upon the type of construction, date of commencement, location and selection of materials.* Treasury figures predict the carbon price will have an inflationary effect and drive wage prices up suggesting an increase on wages of around 0.7% and 1.0% which could add a further 0.5% to the estimated construction cost of building.

For more detailed analysis of the impact of the CPM on construction view WT Sustainability's full report at http://wtsustainability.com.au/2011/09/carbon-in-construction/.

*This increase is for the cradle to gate process only and does not take account of transportation, labour during construction, operation of the building and / demolition and recycling.

*'Calculations undertaken by WT Partnership's sustainability consultancy practice, WT Sustainability, on manufacturing and material processing indicate a nett trade cost increase between 0.4% and 0.7%...'*

Nick Deeks, WT Sustainability & WT Partnership (Sydney)

# Infrastructure

The most recent ABS data indicates a drop of 5% in engineering construction work undertaken during the September 2011 quarter from record 50% growth in the twelve months prior.

Softening of the rate of work is to be expected but major resources infrastructure projects in Queensland, Western Australia and South Australia will keep the rate of work at near record levels.

Major capital expenditure projects including Queensland's liquefied natural gas pipelines and processing plants, the Gorgon Gas Project in Western Australia and BHP's Olympic Dam Project in South Australia will continue to feed jobs growth in these states as workers from the south east of the country either relocate or take on fly-in fly-out roles.

This however is beginning to create a skills void in other sectors and driving up labour costs across the infrastructure sector nationally. The impact of the Carbon Price Mechanism is also expected to have an effect through increased fuel costs on operational vehicles, fly in fly out arrangements, domestic shipping and rail/freight.

The skills drain is also impacting on the availability of professional staff in the South East States, driving rises in consultancy fees attracted by major projects.

WT PARTNERSHIP

# WT Partnership is an internationally renowned professional quantity surveying and construction cost consultant and service provider to the property, building and infrastructure construction sectors throughout Australia and around the world.

WT Partnership is wholly owned by the Principals of the Practice, who ensure that independent advice is solely aligned to our clients' desired project objectives.

WT Partnership draws on the collective experience, knowledge and capability of over 1,000 professional staff in 49 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.

### 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.

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