Ivanhoe Gardens by Blue Earth Group

What’s Next for Inflation?

MaxCap Group Research - July 2023

What’s next for inflation?

The big blowout. Supply chain disruptions and elevated energy prices have combined to drive an outbreak of global inflation not seen since the 1970s. The inflationary surge for housing construction is even more severe, marked by outsized price gains for all types of building materials.

After the peak. In 2023, there are more consistent signs of slower inflation (or prices rising at a more moderate rate). Indeed, swiftly responsive inputs like fuel and steel are already showing outright price falls. Meanwhile, slower and less responsive inputs like timber, tiles and cement are still showing price gains, albeit at a more subdued pace.

Comes the descent. After the peak, the step down in price inflation will look much like the initial step up in reverse. Historically, the cost passthrough – both over time and across different components – follow a consistent sequence upwards and downwards. In short, the construction sector is on track for a broader phase of slower inflation in 2023 and 2024.

The big squeeze. Higher input costs have been driving a big squeeze on construction profits and some high-profile builder failures. As cost inflation ease and sales improve, the worst of the cost squeeze is now behind us, as builders move to restore margins in a strengthening residential market with considerable undersupply.

Building in more headroom. In this new landscape, builders are resetting their feasibility thresholds to account for higher materials and funding costs. Notably, contract builders are opening their books, moving off fixed-cost contracts and building in more contingencies to account for cost and other uncertainties.

Implications for construction. The unexpected surge in costs since 2020 has reshaped the building and contracting landscape in 2023, as inflation eases and builders move to restore profit margins, at a time when selling prices are showing a strengthening rebound.

After the peak

After the disruptive lockdowns of 2021 and the energy price shock of 2022, the global economy experienced **a surge in price inflation** not seen since the OPEC oil crises of the 1970s.

In late 2022, Australian consumer price inflation lifted dramatically to 8% or a 33-year high, initially on the back of higher crude oil prices. For the construction sector, **residential building cost inflation** was even more severe at 17% or a 47-year high, driven by big escalations across a wide range of cost components, including fuel, steel, timber, tiles and cement.

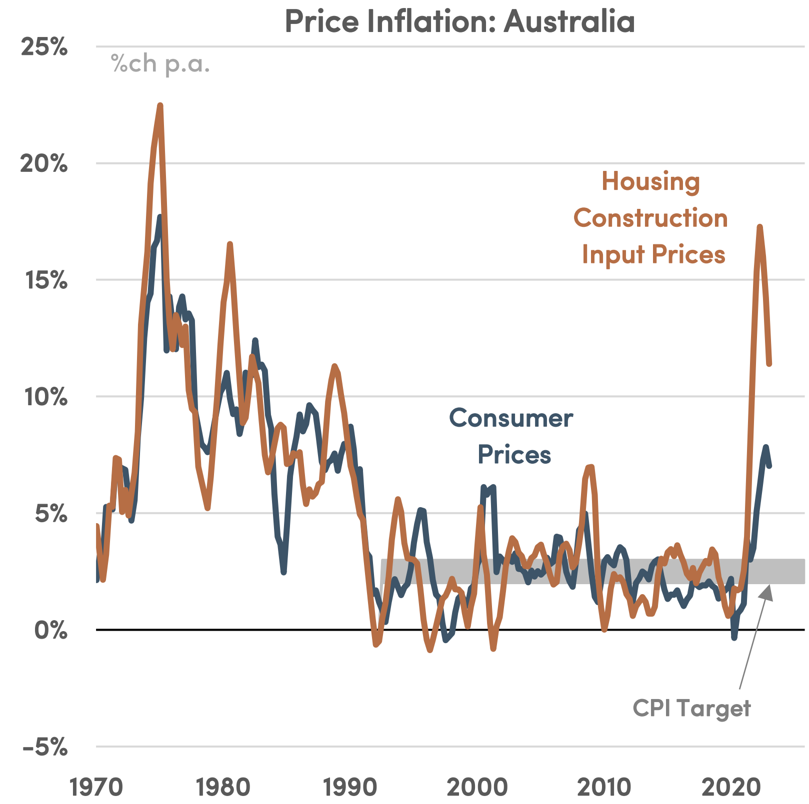
Cost inflation – specifically **unanticipated cost inflation** not factored into fixed-cost building contracts – are quite disruptive for the construction market. Along with the shortage of labour and unseasonably wet weather, this was the primary catalyst squeezing already-thin profit margins and driving several poorly-capitalised operators into insolvency.

In early 2023, there are more consistent and encouraging signs of a peak and subsequent **slowing in price inflation**.

- In the **consumer price index**, this turnaround is slow and relatively modest, still held up by the widespread indexation of rents, transport services, healthcare, utilities, public services and even student debt.
- In the **construction cost index**, there is more apparent scope for moderation ahead, given the larger initial uplift, but also as some components of construction costs are now starting to fall outright.

To be clear though, prices are still rising in aggregate, albeit at a more moderate pace since the peak. As the construction sector moves past this period of maximum inflation stress, investors are asking some timely questions, particularly… **What happens next with inflation?** How does this unfold? What are the implications for the building sector? How does all of this affect the risk profiles for equity and debt investors?

The big surge in consumer and building price inflation looks to have peaked in 2023, although the subsequent moderation phase will likely take some time to realise.



Source: Australian Bureau of Statistics, MaxCap Group (July 2023)

One turning point at a time

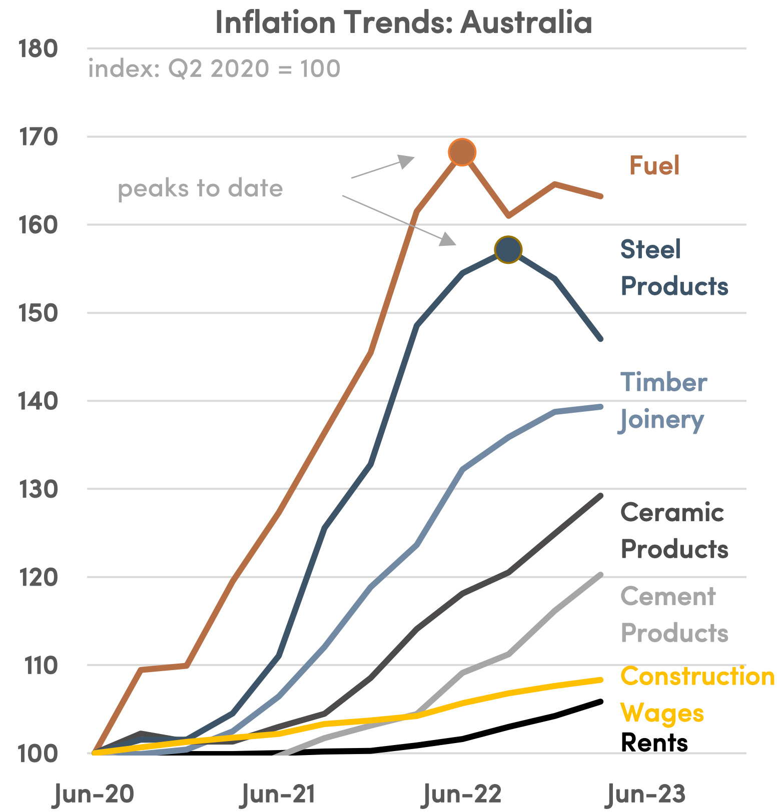
To get a better sense of **where headline inflation is headed** over the next year or two, it is instructive to look a little more deeply into the components of inflation and their respective drivers. In other words, the headline inflation numbers tell a very incomplete story, but the components provide much more guidance about the inflation outlook.

For each historical inflationary episode, when we review the initial shock and the subsequent cost passthrough, we can see a fairly consistent pattern of adjustment with those previous pricing shocks.

- **Inflation starts with oil.** Historically, inflation shocks mostly start with crude oil and other energy prices. Indeed, energy is a vital input into all forms of economic activity and one with the most price volatility. With the war in Ukraine, energy prices spiked in early 2022, before it found a peak mid-year, with a subsequent but partial moderation into 2023.
- **Steel is an early mover.** Steel products are highly and swiftly reactionary to energy prices, particularly given its high coking coal content. Already, steel prices are showing outright falls, partly reflecting lower energy prices and partly due to a weaker global economy.
- **Other inputs turn more slowly.** Meanwhile, prices for other building materials are still on the rise, but the pace of inflation is moderating. In history, the inflation responses here take longer to realise, typically around 6 months for timber and 12 months for ceramic tiles.
- **Wages move swiftly.** Construction wages tend to response quickly to inflation shocks, as we see again this cycle. Already, construction wage inflation has been moderating since mid-2022, with wage growth already falling below manufacturing, utility and finance sectors.

In prior inflation cycles, the passthrough of costs followed a consistent pattern. In short, we can track the adjustment **one turning point at a time**. Already, fuel and steel prices are falling outright, while wages, timber and concrete are showing slower price gains.

In construction, there are many sources of price inflation including building materials, fuel and wages. The early movers are starting to ease from their peaks.



Source: Australian Bureau of Statistics, MaxCap Group (July 2023)

The big squeeze

Amid a challenging global economic environment and the biggest **inflation shock** in over 30 years, the Australian construction industry has gone through a difficult adjustment over the past year.

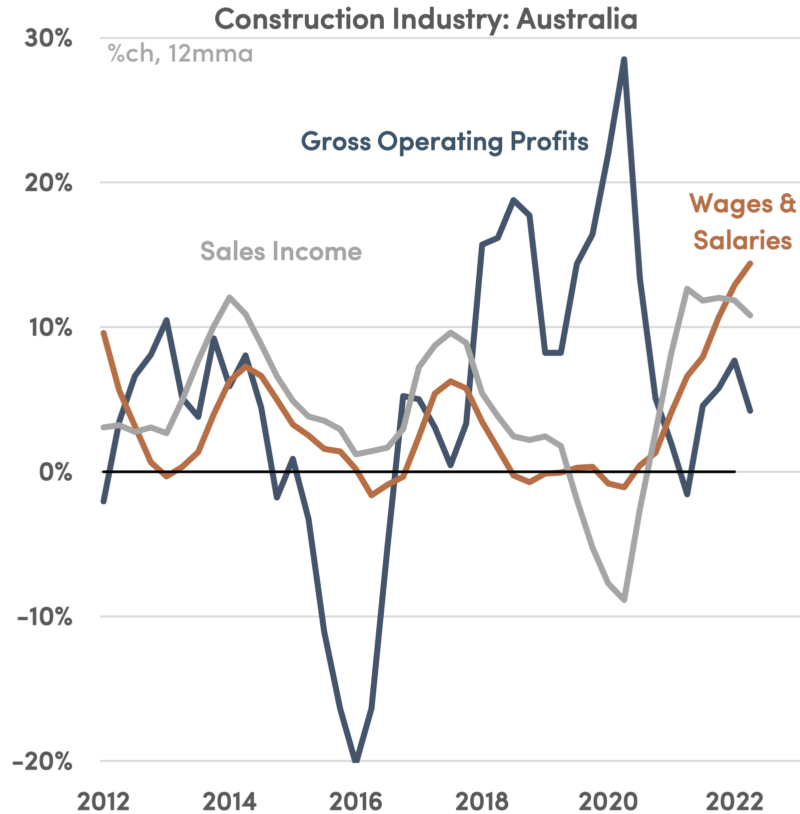
- Indeed, the surge in building cost inflation has been the most challenging concern. Specifically, **unanticipated cost inflation** for builders committed to fixed-cost contracts had the most dramatic impacts on their firm-specific profitability, even if they were able to renegotiate their project costs.
- Altogether, we have seen **a big profit squeeze** in the construction sector in 2022 and 2023. Higher rates, higher construction wages, higher building material costs and even wetter-than-usual weather conditions have all added to costs and delays within the sector.
- Coming off the back of timely JobKeeper and other government support payments during the COVID lockdowns in 2020 and 2021, we have seen a clear slowing in the **construction sector profitability**, which has eased from a peak 11% of sales in 2021, back to the long-term average of 9% of sales in early 2023. However, it is important to put this into longer term perspective, as building sector profitability has only eased **back to their 20-year averages** in 2023.

In our view, the period of **maximum margin stress** occurred in 2022.

- Since then, builders are actively embedding the higher cost base into **subsequent building contracts**, leaving much more room in contingencies to reflect the increased uncertainty in costs and completion timing. There is an encouraging shift to open book discussions to promote cost transparency. Contractors are also building in much more contingencies to account for cost variability.

All of this is occurring as cost inflation moderates from the peak in 2023, with more components reporting outright price falls.

The construction sector has had a difficult time over the past year, especially as higher input costs and higher interest rates combine to squeeze sector profitability



Source: Australian Bureau of Statistics, MaxCap Group (July 2023)

Implications for investors

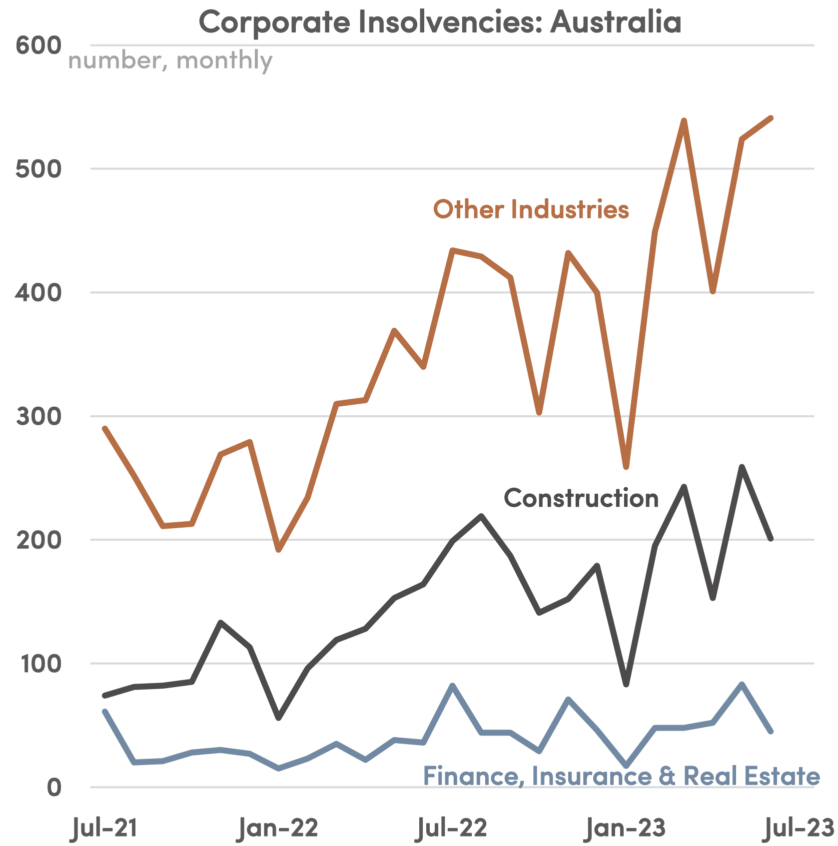
For many investors, the most telling consequence of this inflationary shock has been the increased instances of **corporate insolvencies** in Australia, both in the construction sector and elsewhere in the economy.

- Historically, corporate insolvencies are **a lagging indicator** for the state of economy, given the tendency for distressed firms to hold on for as long as possible, even as the capital markets and broader economy move past their turning points into a cyclical recovery.
- Importantly, the **counterparty for investors** are not the builders, but the financial sponsors and developers who contract them. While distressed or insolvent builders erode the profits for the real estate developers, the insolvency rates for the finance and real estate sectors remain relatively low and stable.

As we move more convincingly beyond this round of cost inflation (and squeeze on building margins), there are positive strategies for investors to manage this adjustment and take advantage of the subsequent upswing.

- **A time for active management.** While cost pressures are starting to ease, there is still an important role to actively manage the loan book, to keep on top of borrower cash flows and repayments.
- **A time for sponsor selection.** There is a big performance gap between the top and bottom performers in construction. In a market where competition from bank lending is softening, we see considerable scope to invest and select on the basis of developer or sponsor quality, particularly on their track record and balance sheet strength.
- **A time to rebuild margins.** With rising sale prices and easing cost inflation, there is ample opportunity to restore profit margins eroded by this round of inflation. The focus ahead will be firmly on timely project delivery, cost control and contracts that take better account of elevated cost and timing uncertainty.

A slower economy and higher costs have combined to induce greater stress, more so within the construction sector, and less so for their financial sponsors



Source: Australian Securities and Investments Commission, MaxCap Group (July 2023)

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