Construction Update: Sunnier Days

MaxCap Group Research – May 2024

What is the outlook for construction?

Revisiting the outlook. The health of the Australian construction sector remains a key area of focus for both equity and credit investors. In this report, we take a timely review of the sector outlook, noting the recent trends in costs, profitability and the degree of financial distress.

Past peak inflation. The worst price shock since the 1970s looks to be behind us, as construction cost inflation slows sharply. Building costs are finding their peak and may fall outright. This is only a partial unwind, but it does provide much-needed relief for stressed builders.

Sunnier days ahead. Indeed, the adverse profit drivers of recent years are now unwinding, particularly as construction costs stabilise, final selling prices rise, interest rates approach a cyclical peak, and we move back to sunnier weather in the more populated parts of Australia.

A more profitable vintage. In this context, we are expecting a distinctive shift in construction profitability, as builders move on from the loss-making projects from 2022, into what is shaping up to be a progressively more profitable set of projects in 2024 and beyond.

Diminishing builder distress. Meanwhile, the profit squeeze of recent years have driven more builders into insolvency. As these profit drivers improve, we expect construction insolvencies to slowly decline from here, even in the face of a broader economic slowdown in 2024.

Implication for investors. From a credit perspective, there is still a lot of work to do, even as cyclical conditions improve, to keep an eagle eye on builder / developer performance, particularly in terms of their cost management, project profitability and capacity for loan servicing.

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A fading price shock

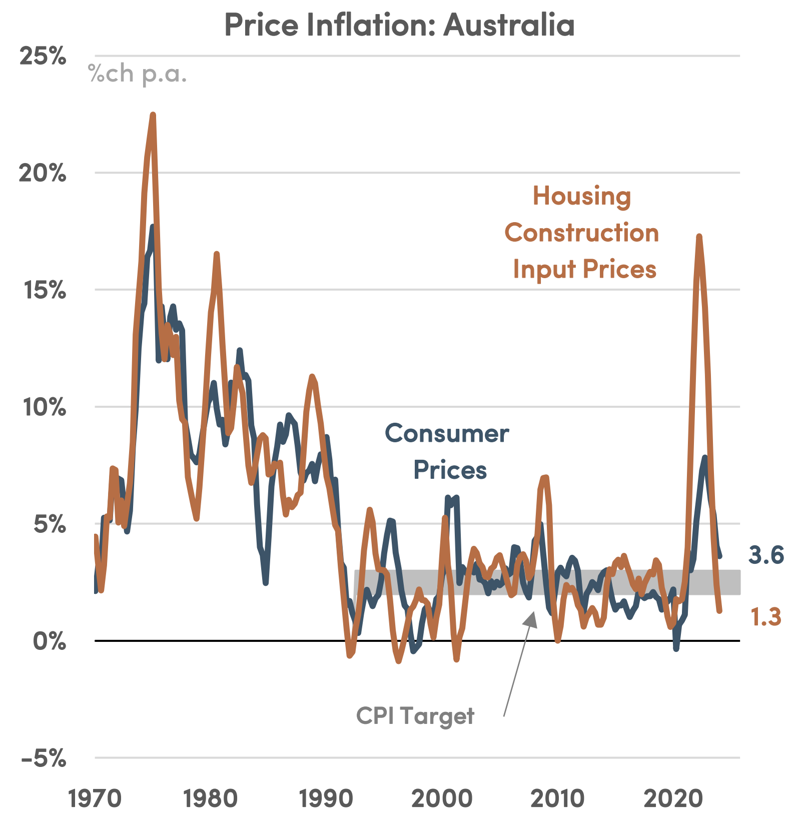
For several years, the global economy has been bedevilled by a sizeable surge in **price inflation**, on the back of crippling supply chain disruptions and markedly higher input costs.

- Undoubtedly, this was the strongest bout of inflation since the **global oil price shock** in the 1970s. Consequently, both households and businesses saw sharp erosions in real purchasing power, further compounded by aggressive increases in policy interest rates.
- In 2024, there are more encouraging signs of slower inflation taking hold, most notably in **consumer prices** – the focus for interest rate settings – as key headline and core inflation indicators look on track to return to the official 2% - 3% target band sometime in 2025.
- As inflation moderates, the door opens for a potential series of gradual **interest rate cuts**, likely starting in 2025. In other words, this fading price shock may provide some modest but much needed relief for the economy via reduced borrowing costs.
- The lingering issue – particularly for interest rate settings – is whether this moderation phase of disinflation continues, or we see a renewed bout of inflation, this time driven by more **traditional demand pressures**, specifically from the tight labour market, and the push for higher wages.

Meanwhile, we are also seeing a corresponding slowdown in **construction cost** inflation, which – for the real estate sector – has arguably a more direct and material bearing on improving builder profitability and reducing financial distress.

- Indeed, there is growing confidence that the worse of the **inflation shock is behind us in the construction sector** as well. Looking ahead, the unresolved questions over the next year are… How quickly will this round of cost disinflation unfold? More importantly, how much would this easing inflation profile translate into better profitability?

There are more consistent signs of slower inflation taking hold across the Australian economy, after a short and sharp period of runaway price inflation since 2021



Source: Australian Bureau of Statistics, MaxCap Group (May 2024)

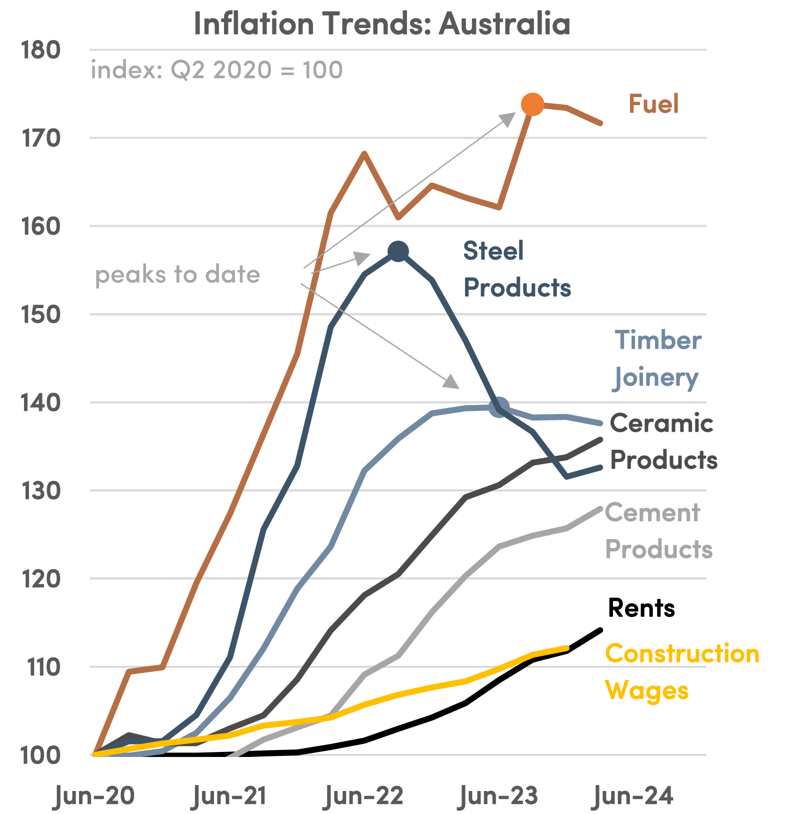
Easing cost pressures

The moderating profile for consumer price inflation is also playing out on a broadening basis in the **construction sector**.

- Indeed, with **the peak in construction inflation** in 2022, there has been a relatively sharper moderation since then. In 2024, there is likely to be further easing in building cost inflation to come, judging by the turning profiles for specific input costs.
- When we look to the **individual components** of the construction cost basket, we can see the sequential adjustments in each cost category, as they inflate, stabilise, moderate, and in some instances deflate. Indeed, fuel, steel and timber prices are mostly past their cyclical peaks for this inflation cycle and prices are now falling outright.
- In 2024, there is likely to be broadening declines in other cost components. We can say this because this is the **typical adjustment process** in building cost components, observed over the past 40 years and multiple pricing cycles, where inflation shocks are consistently passed through more quickly along the supply chain for some components (e.g. fuel) and more slowly in others (e.g. ceramics).
- Of course, the key unknown element in the outlook relates to **construction labour costs**, with the industry still being hampered by skilled worker shortages and rising wages. The unwind in these labour market pressure points will likely be a little slower, but it will be facilitated by the strong migratory inflows of new workers from abroad.

Altogether, the construction sector is on track for **slower inflation** in 2024 and 2025, partially unwinding the initial price shock. To be clear, this is not a complete unwind, and the construction landscape has undoubtedly changed due to this mostly permanent uplift in costs.

There are progressively more cost components reporting outright price falls, driving the quickening slowdown in overall construction cost inflation



Source: Australia Bureau of Statistics, MaxCap Group (May 2024)

Rebuilding profitability

With strong housing demand, rising prices and slower cost inflation, the Australian **construction outlook** is set to improve in 2024 and beyond.

- The market turbulence of recent years played out very clearly in **construction profits**. In 2021, the impacts of disruptive COVID-related lockdowns and dramatic supply chain breakdowns, followed in 2022 by rapid increases in interest rates and construction site delays from unseasonably wet weather, all combined to harshly impact profitability in the building sector.
- In 2024, the outlook for the construction sector is improving noticeably, as more of these **adverse profit drivers unwind**, particularly as supply chains resume, construction costs stabilise, interest rates peak and sunnier weather reduce site delays. Altogether, this is clearly supporting a rebound in profit margins across the building sector.

While we expect a broad-based recovery to unfold nationally, there is likely to be a lot of **regional variations**, reflecting local market drivers.

- In **New South Wales**, there is a firmer construction outlook with the proposal to rezone around major rail stations. Planning remains the key bottleneck in Sydney. The forthcoming enterprise bargaining agreement will sustain elevated wage inflation for several years ahead.
- In **Victoria**, there is a forthcoming shift towards residential construction, as major infrastructure projects are completed or cancelled. There is a greater focus on build-to-rent in Melbourne, as a reduction to withholding tax spurs inbound foreign investment.
- In **Queensland**, major builders are slower to come off the sidelines, awaiting further improvement in profitability. There is still considerable uncertainty around the construction pipeline for the 2032 Olympics.
- In **Western Australia**, softer commodity prices are slowing the mining sector, releasing some capacity in a tight local labour market. Cost escalation and delays are more prevalent, given long supply chains.

Profits are bouncing back in both the construction and real estate sectors, despite higher material and funding costs, as rising sales revenues support better margins

Source: Australian Bureau of Statistics, MaxCap Group (May 2024)

Declining distress

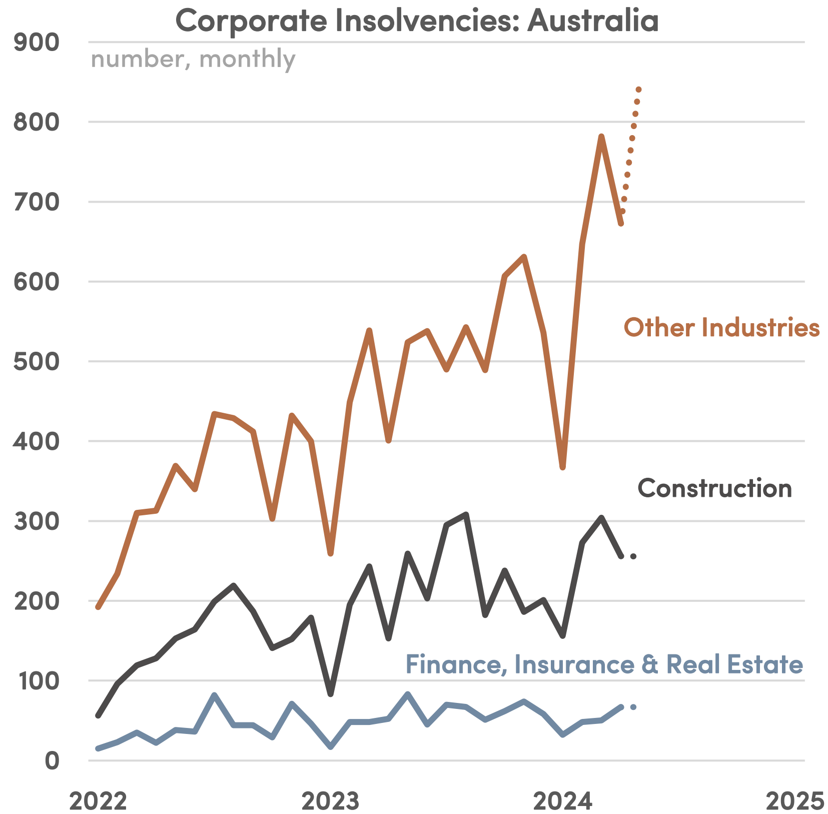
For investors and lenders linked to the construction sector, **business insolvency** presents a critical risk to the outlook and a key indicator for continuous review.

- Certainly, the operating environment for builders has been especially challenging, given the earlier bouts of cost escalation and supply chain disruptions in recent years. It is not surprising to see this reflected in the **rising rate of insolvencies** in 2022 and 2023.
- That said, insolvencies are **a lagging signal** for the economy. Given a bout of financial distress, businesses are always inclined to hold on and trade for as long as possible, even after the initial shock fades and the sector rebounds into recovery.
- In 2024, we are expecting a gradual declining trend in financial distress, which should slowly translate into **lower construction insolvency rates ahead**. Moreover, distress in the financial and real estate sectors remain exceptionally low and steady, little affected by the sluggish economy. Notably, this trend is quite distinct from what is happening in the broader economy, where slower activity growth and high interest rates continue to weigh heavily on consumer spending.

To sum up, there is a broadening set of drivers supporting **a turnaround in the construction sector** in 2024 and beyond.

- The sharp spike in construction **cost inflation** is clearly unwinding, as more cost components find their cyclical peaks for this cycle. At the same time, these costs are being passed onto to buyers, given the broad and sustained increases in selling prices. **Funding costs** remain elevated – and while the outlook for peak interest rates are being pushed out – there is a broad consensus for modestly lower rates from 2025 onwards. Overall, we are likely past the period of maximum financial stress for the construction sector, with improving profitability and declining builder failures over the course of 2024 and beyond.

Corporate insolvencies are still high overall, but construction companies are starting to trend lower, while real estate & finance companies remain resilient.



The dotted lines show the extrapolated outcome given partial monthly figures.
Source: ASIC, MaxCap Group (May 2024)

Additional information

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