

Construction market outlook through September 2010

The text below is an extract from 'What's next?' *Australian Market Forecast 2009/2010* published in September 2009 by BCI Australia Pty Ltd. Data from this forecast was presented at IQA 52nd Annual Conference by Thor Kerr, who is a director of BCI Australia and Managing Director of BCI Asia. The complete document can be ordered from BCI Australia (www.bciaustralia.com).

BCI Economics is the analytics and forecasting arm of BCI Australia Pty Ltd, the leading information service for the construction industry here and in Southeast Asia. By our very nature, we are not statisticians but researchers and marketers. Hence, this report has a research and marketing focus: it intends to shed light on how important segments of the construction market will emerge from the downturn, and to provide tangible information for decision makers to act upon. We base our analysis on over 70,000 projects in Australia researched per annum, involving conversations with thousands of project decision makers every week. This is a summary of our findings:

- The construction **projects** market (building and engineering construction activity, largely excluding detached housing, mining and oil & gas) has shrunk last year by close to 8%, and we expect it to contract by a further 11% in 2009/2010.
- Due to excess capacity resulting from over investment in the years of the resources boom the commercial and industrial sector will decline dramatically. Medium and multi-density construction will not recover in 2009/2010 but we think it is plausible that dwelling commencements as a whole will make a reasonably strong recovery.
- This makes the construction market in 2009/2010 very much dependent on the continuation of government investment. The Federal Government's BER Program, the Social Housing Fund, the Health and Hospital Infrastructure Fund and the Nationbuilding Infrastructure Package for roads, rail and ports, albeit rushed, have greatly assisted in stabilising overall construction demand. We estimate that if these programs were not in place the market could decline by as much as 35%.
- Education and Health are the two golden sectors of opportunity in the year 2009/2010 because of their massive stimulus support packages. Infrastructure and social housing will be strong. Retail will have quite a bit of orders to work through, but new commencements will be weak.
- The rate of project deferral and abandonment spiked dramatically during the height of the global financial crisis. Some sectors of the market saw one in five projects put on hold or aborted. Deferrals and abandonments have decreased since then to manageable pre-crisis levels.

- We estimate that the total project value lost on account of project deferral and abandonment during the downturn was between \$11 and \$12 billion. These would-be construction starts will be sorely missed in the year or two ahead.
- Stakeholders in the construction industry are relatively unfazed about their economic situation, with 20% saying the crisis brought them new opportunities, 20% saying all was business as usual, 40% saying they expected things to be getting a bit tighter and only 20% saying their firm was going into survival mode.
- Overall there is a healthy sense of optimism about the future: while 24% think the construction market will get worse in the future, twice as many think they will get better.

Every three quarters BCI gauges the short to midterm prospects of the construction market by forecasting construction starts 12 months out. The following forecasts pertain to a number of specific sectors of the construction market. Our focus in presenting this information is less the adherence to taxonomical conventions (e.g. as established by the Australian Bureau of Statistics), but more so the marketing focus of our clients and industry partners. As such we focus, for instance, on 'aged care' rather than 'institutional' or 'other social buildings'. In a nutshell, our research and forecasts cover construction projects of a size of \$100,000 or more, including all infrastructure and mining related construction but excluding a larger part of the detached housing market (which follows different distribution channels and procurement rules than the projects market). In that vein our information is relevant for anyone 'chasing projects' in the construction market. For the purposes of our forecasts we have excluded the mining and oil & gas sector as areas that warrant separate attention.

The construction market will shrink again in 2009/2010. Access Economics predicts that construction output in 2009/2010 will fall by 7.9%. BIS Shrapnel believes that the total value of building commencements (excluding the engineering construction market) will grow by 7% on the strength of a rebounding housing market, but predicts that non-residential building commencements will contract by 7%. BCI's perspective reflects some of both predictions. Like the ABS and BIS Shrapnel (the latter working with BCI information) we focus on construction starts. Given that the focus of our project leads research is broader than the traditional 'building sector' (i.e. including both building activity and engineering construction activity) but excludes much of the detached individual housing market, our definition of the 'construction market' has to be considered somewhat in isolation, in that it focuses specifically on the project aspect of the market. Pursuant to this definition we expect the construction market will shrink by 10.8% in the fiscal year 2009/2010 (see Figure 1) after a contraction of 7.6% in 2008/2009. This forecast takes into account the significant investments the government is currently undertaking to support the market.

Figure 1: Total construction starts forecasts for quarter 3/2009 through 3/2010

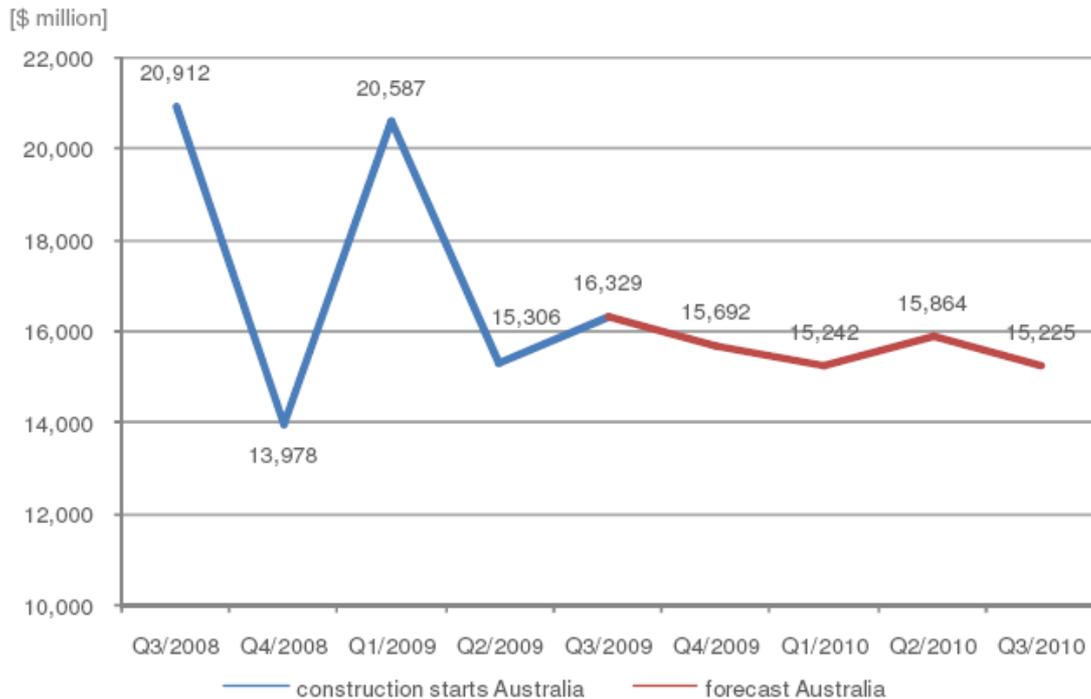
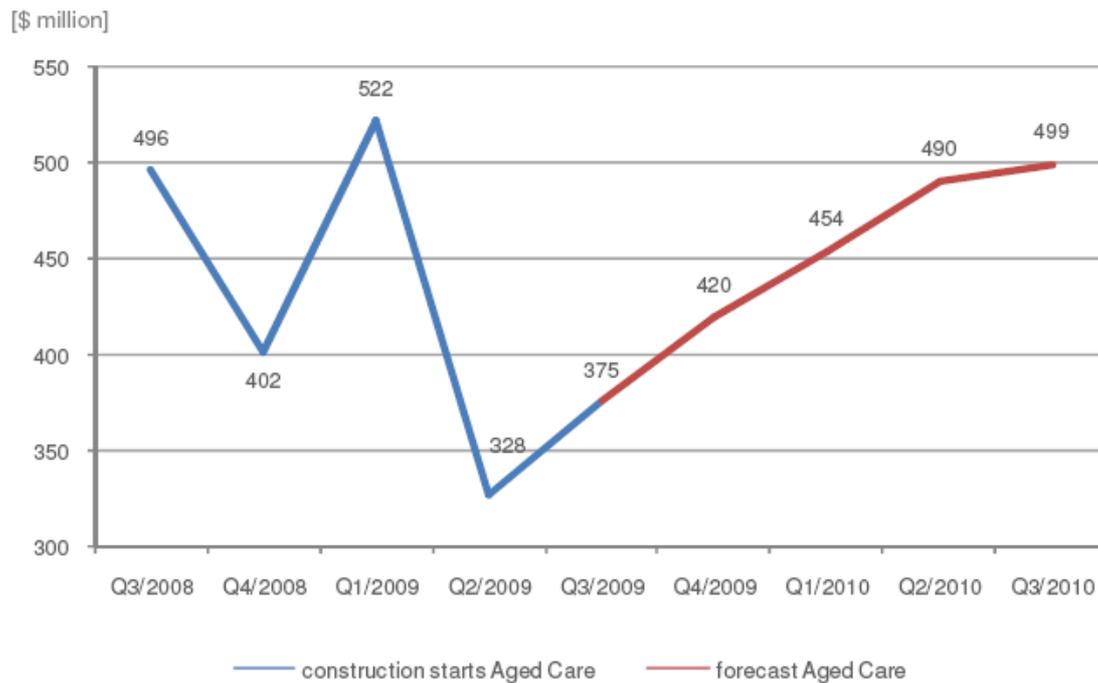


Figure 1 shows historical construction start volumes (in millions of dollars) as determined through recent queries of our project database, as well as forecasted construction start volumes for the next 5 quarters. The relatively ‘flat’ trend is deceiving, as it masks the significant ups and downs of individual construction sectors. We have studied thirteen such sectors (or categories) in greater detail.

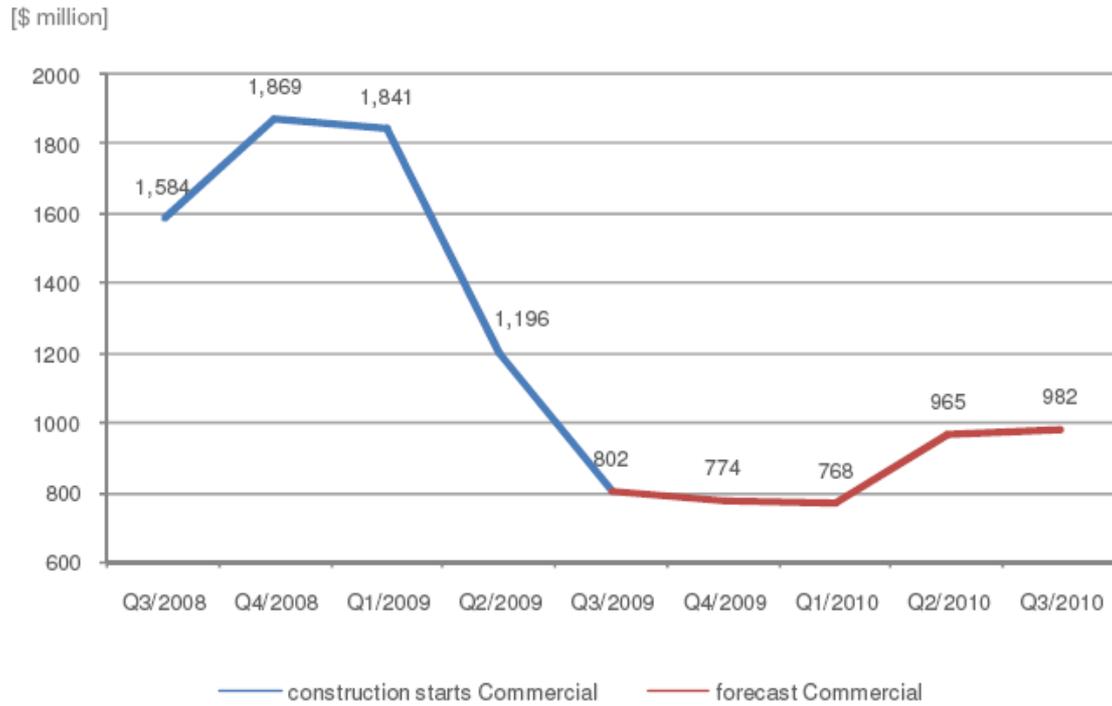
Aged care projects will continue to suffer somewhat under the continuing fragile economic environment and the banks’ restrictive lending practices. Having said that, the underlying demographic demand is high, and so we expect this sector to grow for the next four quarters (see Figure 2).

Figure 2: Aged care projects outlook



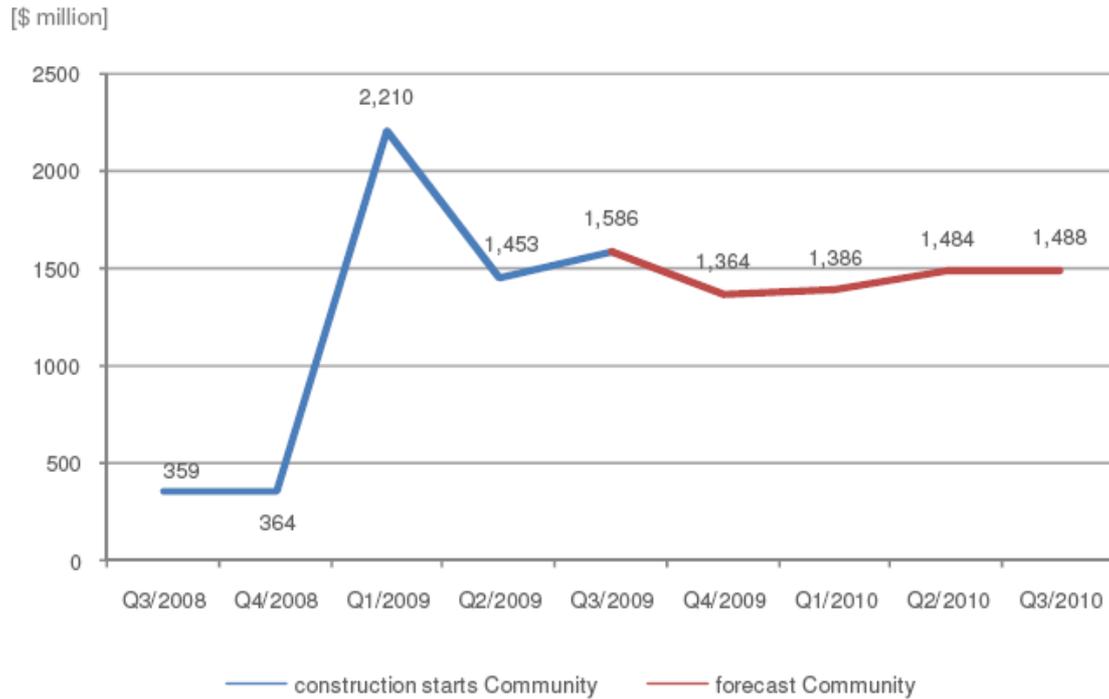
Commercial construction starts will witness a dramatic drop of around 50% in 2009/2010 (Figure 3). Owing to a significant over investment in this sector during the last couple of years yields have blown out and property prices fallen. The financial crisis and restrictive lending by the banking community have further worsened this sector's outlook. However, the most significant issue for commercial construction is that capacity has to be absorbed and rents have to rise before it makes economical sense again to build offices. The driver of the next 18 months is hence the current weak leasing market. We estimate that the market may drop as low as a third of its one-time peak before it starts growing again in 2 – 3 years.

Figure 3: Commercial projects outlook



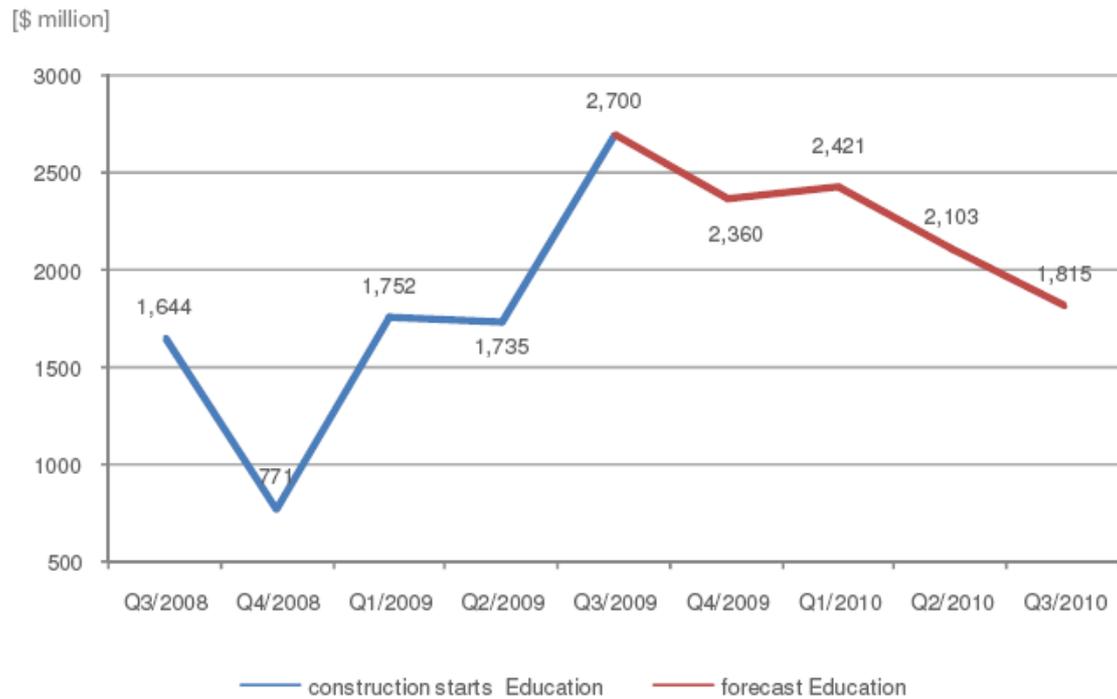
Community construction includes in BCI terminology council developed projects, legal projects as well as social housing and military installations. Construction starts in this sector had seen a recent spike when two very large projects in Queensland (the Queensland Supreme and District Courts and the Lotus Glen Prison extension and upgrade) moved to construction in Q1/2009. With continuing funding available due to increased government spending (especially the Federal Government's housing grants) we see this sector travelling on a very healthy level throughout 2009/2010 (see Figure 4).

Figure 4: Community projects outlook



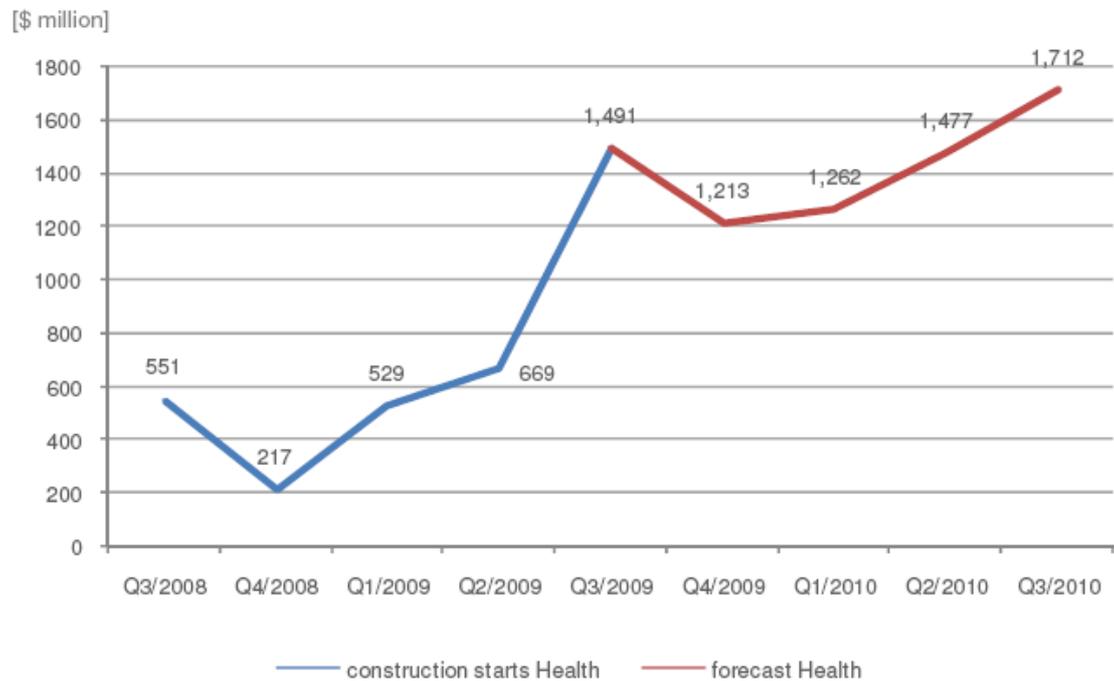
Construction in the education sector is witnessing an unprecedented boom on account of the Federal Government's BER Program. With \$14 billion rushed into the funding of school projects around the country by late 2010/early 2011 we expect construction starts in this sector to rise by well over 60% in 2009/2010 (see Figure 5).

Figure 5: Education projects outlook



With over \$3 billion allocated in the Federal Budget to the Health and Hospitals Infrastructure Fund health project starts should witness a further pronounced incline in 2009/2010, increasing to well over 200% of 2008/2009 levels (see Figure 6). Quarter 3/2009 witnessed a spike when the Royal North Shore Hospital project in Sydney finally got the go-ahead.

Figure 6: Health projects outlook



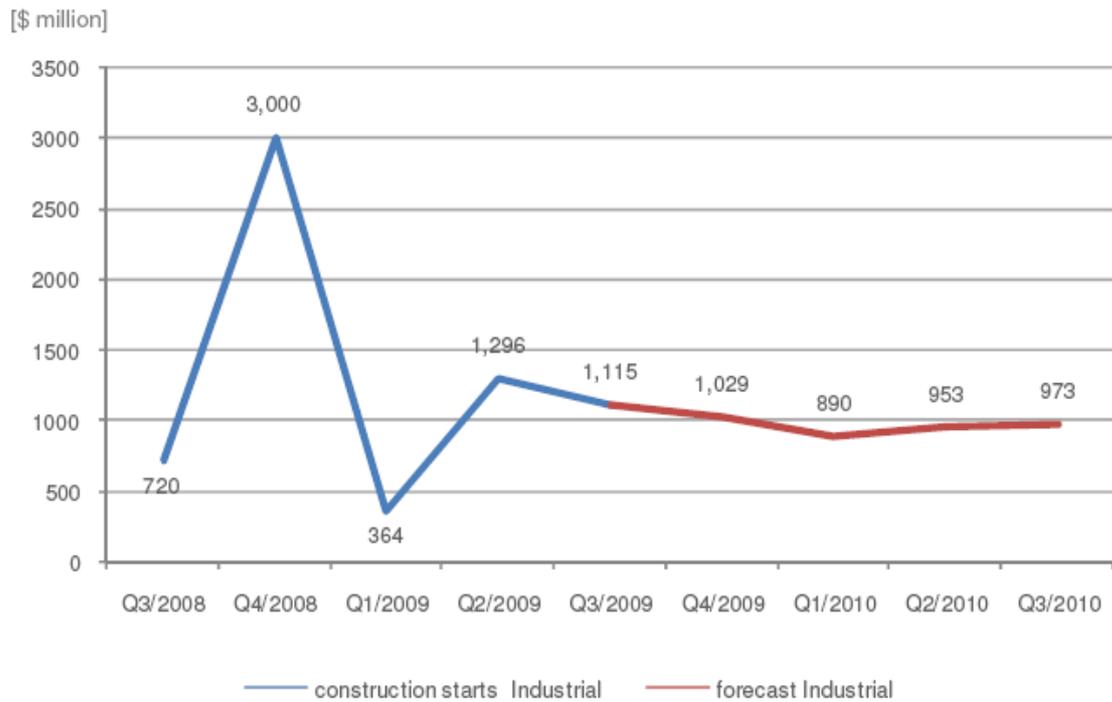
With a slowdown (although comparatively modest) of the tourism market and relatively low room rates in international comparison, the hospitality sector will be slow in 2009/2010 after a sluggish 2008/2009. We expect construction starts to bounce along the bottom for the better part of two to three years until room rates and with them the underlying economics of hotels have improved (see Figure 7).

Figure 7: Hospitality projects outlook



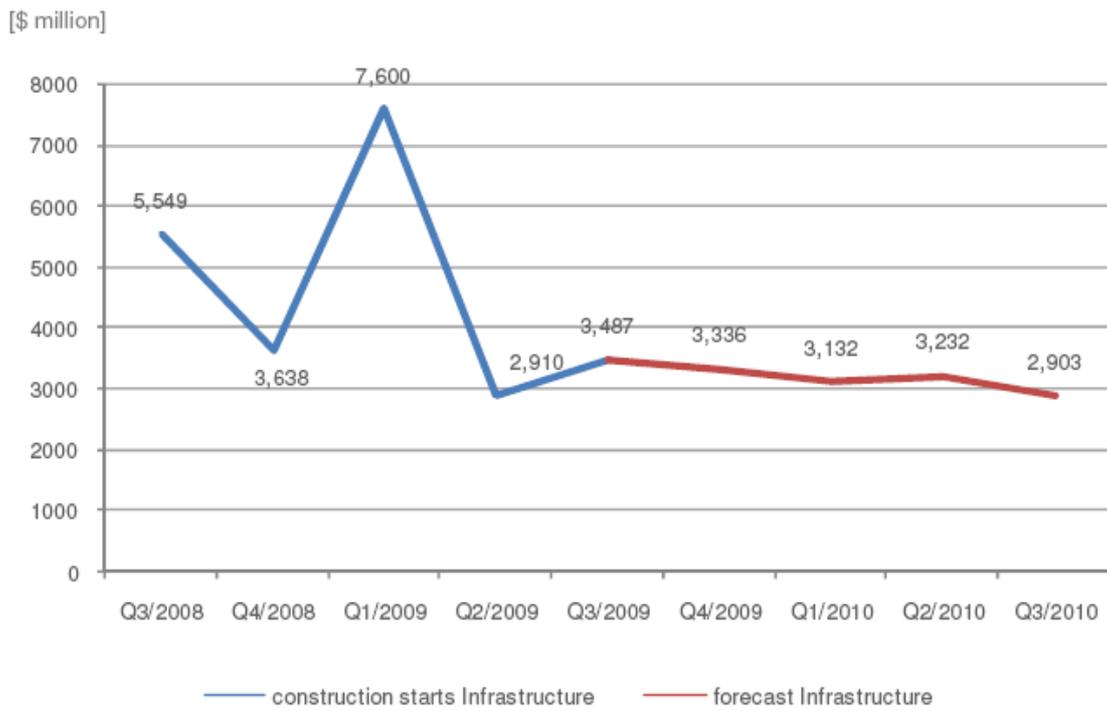
Industrial projects include in BCI terminology factories and warehouses, but also huge mineral processing plants such as aluminium refineries. The start of stage 2 of Rio Tinto's \$2.0 billion Yarwun Alumina refinery expansion in Queensland and work commencement on the \$1.0 billion processing facility of the Sino Iron Project in Cape Preston, WA led to a huge spike in industrial construction starts in Q4/2008 (see page 76 for project details extracted from BCI's project database). The volume of construction commencements in this sector has since fallen, on account of significant overcapacities that had built up over the last five years. We project this sector to contract at the tune of 25% in 2009/2010, with some commentators expecting that construction starts could suffer as much as a 85% drop to pre-1950s levels before they recover (see Figure 8).

Figure 8: Industrial projects outlook



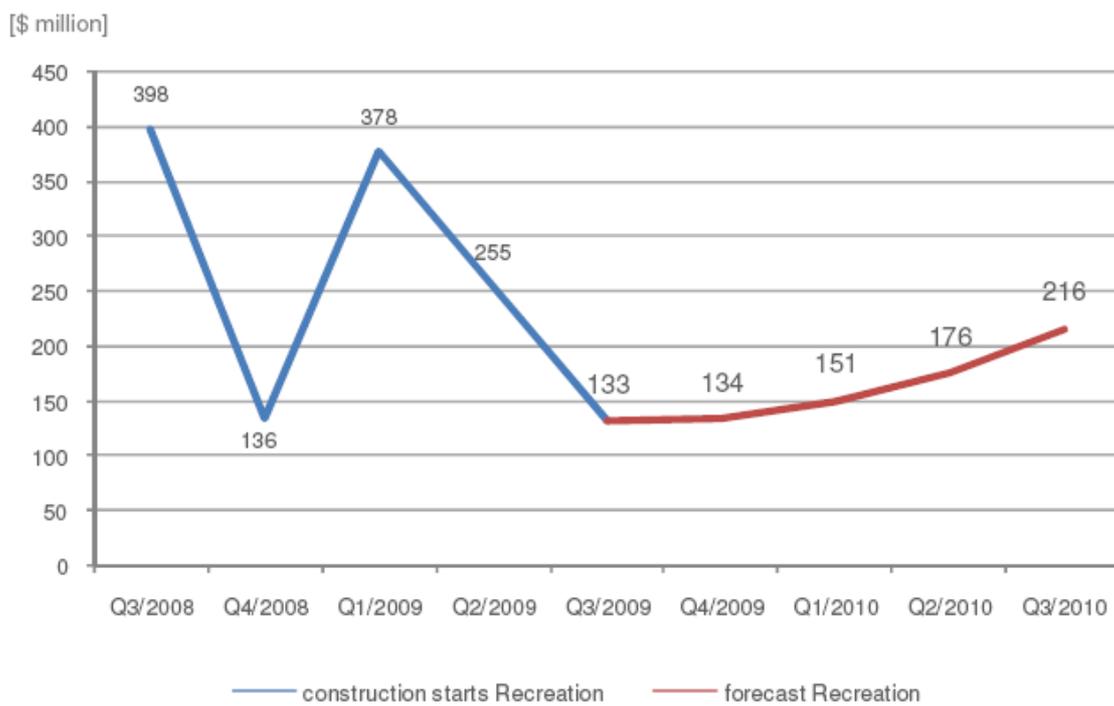
Infrastructure construction is enjoying a huge boost on account of significant government stimulus funding. Federal Treasurer Wayne Swan has suggested that the Federal Government's 'Nation building Infrastructure for Productivity and Prosperity' budget will help over 35,000 building sites to start or continue around the country. \$8.4 billion were allocated towards roads, rail and ports. States and Territories add their own funding to infrastructure, so that we expect this sector to continue strongly throughout 2009/2010. Figure 9 is somewhat deceiving in that it gives the appearance that this sector is trending down; as a matter of fact there was a huge \$3.4 billion spike added to infrastructure construction starts when work commenced on the Brisbane Airport link project.

Figure 9: Infrastructure projects outlook



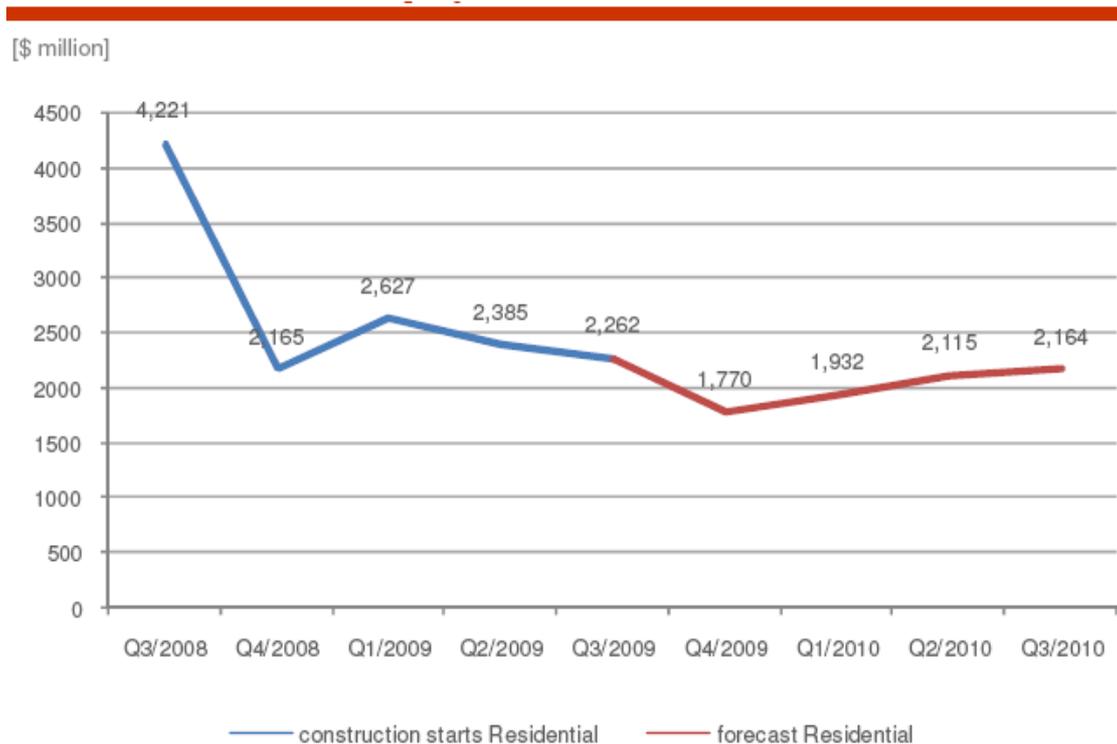
Sport and leisure projects will have a modest run in 2009/2010 with construction starts staying roughly where they were at the end of 2008/2009 (Figure 10).

Figure 10: Recreation projects outlook



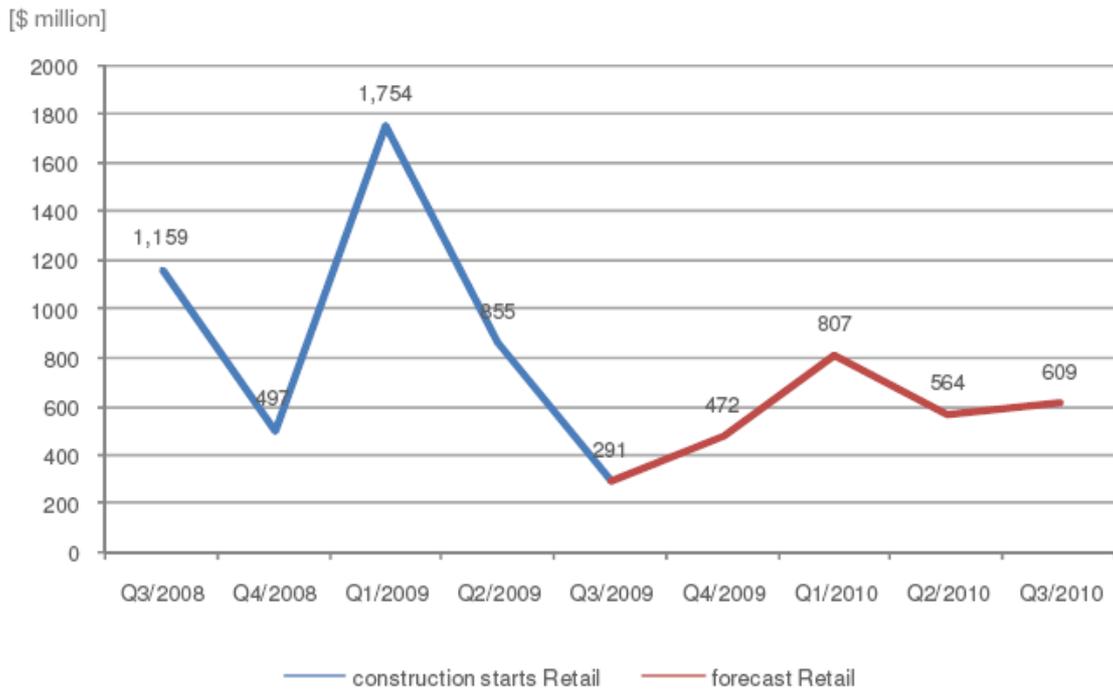
Residential in BCI terminology includes mainly medium and high density residential projects. This sector is currently suffering under the shockwaves of the global financial crisis and the banks' highly restrictive lending practices. Anecdotal evidence shows that a project has to be sold close to 100% off the plan to secure funding. Approvals by local councils and land costs add to the difficulties that are holding back this sector. After a 40% contraction in apartment commencements in 2008/2009 we expect to see a further decline in 2009/2010 before recovery sets in towards the end of 2010 (see Figure 11).

Figure 11: Residential projects outlook



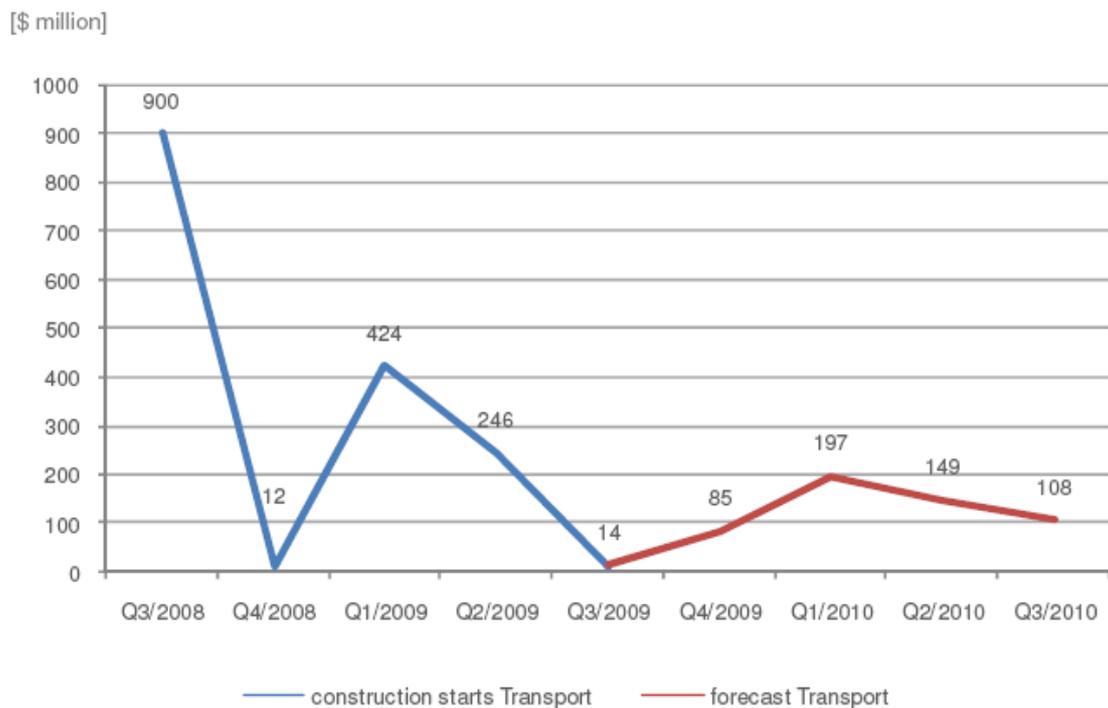
Retail was one of the most vulnerable sectors during the recent downturn, as consumer confidence plummeted to a low point in late 2008. In the meantime, low interest rates, government handouts and a relatively robust jobs market have combined to let confidence rebound with a vengeance. Growth in consumer spending (over 5% in the first two quarters of 2009) has been one of the main drivers of the strong showing of GDP in Q2/2009. Consequently, retail is doing better than was to be expected. In Q1/2009 BCI registered 8 large mixed use projects of over \$100 million involving retail commence construction. In Q2/2009 Westfield announced its plans to redevelop its prime Pitt Street shopping precinct in Sydney. These and other large projects will provide retail construction work into the next year or two; the question is how much new retail construction will enter the commencement stage. From a relatively high base we expect retail commencements to decline to around \$4 billion (see Figure 12).

Figure 12: Residential projects outlook



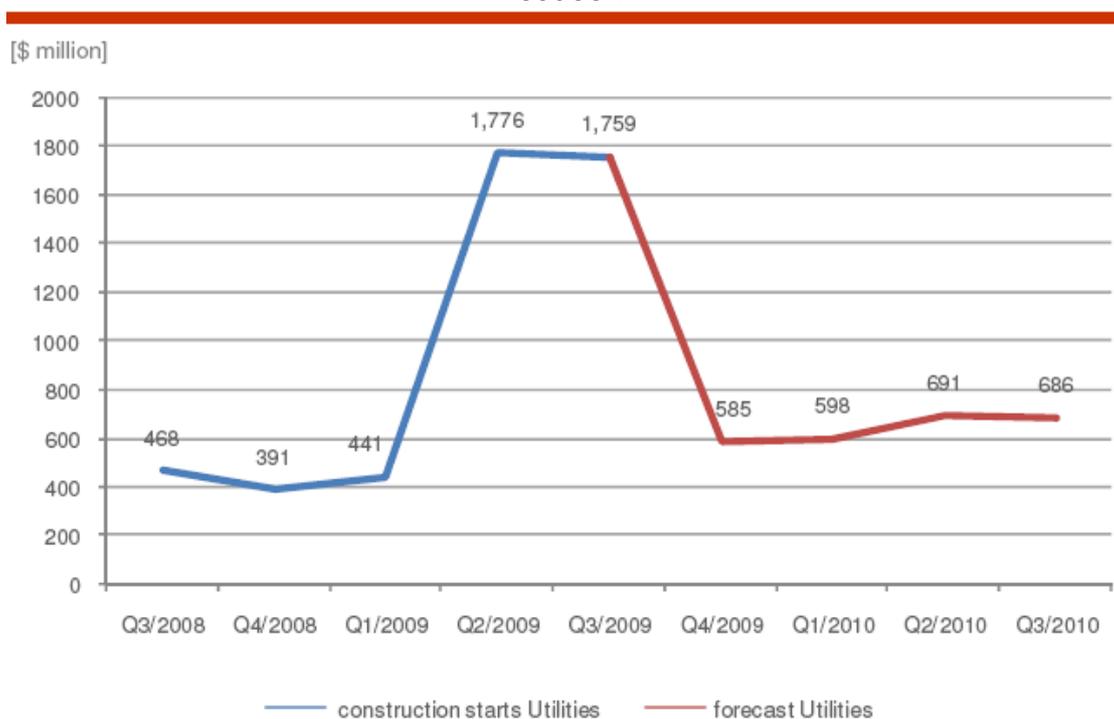
There have been few new transport projects (airports, rail interchanges, etc.) coming on stream as commercial funding shrivelled and the underlying economics of large scale transports became questionable in 2008/2009. We expect construction starts to remain at relatively low levels for all of 2009/2010 (see Figure 13).

Figure 13: Transport projects outlook



BCI registered construction starts for four \$500-million-plus utilities projects in Q2 and Q3/2009, marking a peak of large-scale projects of this nature coming to fruition. The largest of these projects is the Port Stanvac Desalination Plant in SA with a price tag of close to \$1.4 billion. We see utilities construction starts coming off this high with few comparable projects in the pipeline (see Figure 14).

Figure 14: Utility projects outlook



Summary outlook for 2009 and 2010

BCI takes a cautiously optimistic outlook on the construction projects market in the 12 months ahead. Commercial construction starts will continue to be on the back foot, and as built-up oversupply works itself out and banks gradually ease their lending practices, much will depend on the government's continued commitment to supplant lacking private demand. Importantly much rests on the question whether the Reserve Bank of Australia can resist the urge to raise the cash rate back to pre-crisis levels. Our assessment is that the construction market is too fragile to deal well with such a move.