KEOGH CONSULTING

Trend and Outlook for Construction Tender Prices in Ireland 2019

Construction Tender prices continued to increase through 2018[1]. With increases noted of 13% - 16% from early 2017 to late 2018 the tender price increase has potentially raised the estimated outturn cost of projects in planning. Projects on site are not immune too with significant cost increases having recently come to light on the National Children's Hospital project due to Tender Inflation[2].

Once again, the quantum of increase in tender prices experienced emphasises the importance of providing for future tender inflation in feasibility studies and development cost planning – calculation of an appropriate allowance needs to be a key part of financial risk planning for a project. This allowance should be based on four things:

1. The estimate of project costs (including contingencies) at current market prices;
2. The pre-construction and construction period for the project;
3. The procurement and expenditure profile over the design and construction life of the project;
4. Anticipated market conditions.

Amounts provided for tender inflation should be identified separately in a budget and should be incorporated into the individual cost components and adjusted as necessary at various project review stages. This article looks at the current trends in material and labor costs and, based on an assessment of the level of competition, demand and supply in the market, lays out a prediction for future tender inflation illustrating a clear estimation methodology.

Increasing volume of construction output leads to delivery capacity issues.

The output of the Irish construction industry peaked in 2007 at over €38 billion, representing almost 24% of GNP. In 2018 it was estimated[3] that the output of the industry was valued at €25.6 billion (equivalent to c. 9,97% of GNP) – this level is still below the sustainable European level of 10% to 12% of GNP.

The volume of output in building and construction increased by 1.7% in the third quarter of 2018 when compared with the preceding period[4]. This reflects increases in the volume of output in civil engineering work (18.1%) and non-residential building work (0.1%). Output in residential building work decreased by 0.2% in the quarter, possibly due to viability issues associated with residential construction. The change in the value of output in building and construction in the same period was +5.0%. On an annual basis, the volume of output in building and construction increased by 12.0% in the third quarter of 2018 when compared with the third quarter of 2017. Output volumes increased in civil engineering work (27.3%), non-residential building work (17.9%) and residential building work (7.8%). There was an increase of 19.9% in the value of output in building and construction in the same period. Based on ESRI estimates[5] construction output reached €25.6 billion in 2018 and is forecast to grow to €30.2 billion in 2019.

Construction Demand Increasing

At 56.3 in December, up from 55.5 in November, the Ulster Bank Construction Purchasing Managers' Index® (PMI®) – a seasonally adjusted index designed to track changes in total construction activity – signalled an expansion of Irish construction activity. Furthermore, the rate of growth quickened to a four-month high. "These latest results of the Ulster Bank Construction PMI survey show that Irish construction firms experienced solid, and faster, rates of expansion in December. The headline PMI picked up for the second month in a row, with a robust reading of 56.3 marking a four-month high. The Commercial PMI picked up slightly from what was already an elevated reading in November, in the process leaving commercial as the strongest performing activity category last month. Housing activity continued to grow strongly and at a pace similar to that recorded on average during the 2004-06 pre-crisis period, albeit that the pace of expansion moderated from November.

"Momentum behind the sector's recovery continues to look solid, with New Orders continuing to rise solidly in December indicating that activity trends look set to remain positive in early 2019. Furthermore, firms themselves remain optimistic about the coming year with almost half of respondents expecting further growth in activity in the coming 12 months. Positive sentiment about the year

[1] Source: SCSI
[2] Source: Irish Times https://www.irishtimes.com/news/health/rising-cost-of-national-children-s-hospital-a-scandal-in-the-making-1.3739648
[3] Source: CIF Budget 2019 Submission
[4] Source: CSO December 2018
[5] Source: ESRI QUARTERLY ECONOMIC COMMENTARY WINTER 2018

ahead is being underpinned by increased capital investments along with confidence about the prospects of the wider Irish economy more generally."[6]

In addition, with increasing activity in the economy in general GNP is forecast to grow[7] by +4.5% and +3.8% respectively in 2019 and 2020, with growth of +7.8% having been experienced in 2018[8].

Figure 1 - Volume of Construction Production by Quarter and Type[9]

Employment increasing with labour availability putting pressure on wage costs

On account of the increased activity, not surprisingly CSO figures[10] released in November 2018 shows that employment in construction has again increased 14.0% from 129.0K Q3 2017 to 147.0K Q3 2018, still significantly below the noted peak of c. 400K in 2007. Labour costs have also increased with the sectoral employment order giving rise to a 10% wage increase having come into effect. This order combined with continued potential growth in Europe increasing the continents attractiveness as a location for construction workers potentially may add to the skills shortage in Ireland and drive up wages further, with the additional factor of ongoing housing shortage (and nowhere for migrant workers to live) also impacting on net migration of construction workers.

Material Prices Increasing

Wholesale prices of building and construction materials[11] have shown a price increase of 0.1% on average in November 2018. While there have been cost increases in Structural Steel & Reinforcement +2.2%, Cement +3.8% and Plumbing Materials +3.6%, Glass has reduced in cost by -18.5% on an annual basis. Transport and site machinery operating costs have been impacted by a +14.0% and +6.2% annual increase in energy products and petroleum fuels respectively.

Globally construction materials inflation remains bullish at around 5% per annum. Inflation is currently driven by rapidly rising input costs, which the manufacturing supply chain is struggling to absorb. The recent appreciation in oil prices poses a further upside risk. The extent to which the supply chain can absorb these increases is limited. However, some relief may stem from reduced traded prices of key metals used in the construction sector in recent months – potentially a consequence of the escalation in trade tensions between the US and China.

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[6] Source: https://www.markiteconomics.com/Public/Home/PressRelease/4a991c7cb2134923b40839ccbbafbb8e
[7] Source: ESRI Quarterly Economic Commentary – Summer 2018.
[8] Source: ec.europa.eu
[9] Source: CSO December 2018
[10] Source CSO: Labour Force Survey November 2018.
[11] Source: CSO November 2018

Supply Chain Profitability

Financially, the contracting market remains vulnerable and insolvencies are rising[12]. The top 10 contracting organisations typically achieve an average pre-tax profit margin of 2% (Sisk – 2016 1.7%, 2017 3.1%[13]). This is a meagre profit margin relative to other industries and the huge risks taken. The precarious state of contractors' finances drives risk aversion and restricts the supply chain's ability to reduce or hold pricing. Contractors are being more selective in what projects they are bidding for with higher margin work targeted. This selectivity, possible on account of the capacity constraints in the industry, is driving margin recovery through higher tender prices.

Tender Forecast – Increasing through 2019 then moderation

The combination of rising labour and material costs, in addition to capacity constraints in the industry, are feeding into increased tender as firms selectively increase margins in the face of increasing construction demand. The increase in tender prices emphasises the importance of providing for future construction inflation in feasibility studies and development cost planning. On this basis estimates regarding tender inflation over the period to 2020 have been forecast using the following assumptions:

1. Forecast GDP growth in Ireland of +4.5% in 2019.
2. The general rate of CPI inflation forecast at 1.2% in 2019 (0.6% 2018) and 1.4% in 2020. Thereafter it is assumed that CPI inflation is in line with the 2.0% target set by the ECB;
3. Inflation in building and construction materials rises by 4% in 2019 and then by 3% in 2020 and 2021, unwinding some of the material price reduction experienced at the end of 2018;
4. Average labour costs rise by 5% in 2019 and then by 4% in 2020 and 2021;
5. It is assumed that the weighted building and construction cost inflation rate is made up of 60% materials and 40% labour costs;
6. Competitive tendering of projects.

The forecast of cost and tender price indices has been calculated using the following formulas:

Cost Index Forecast = 60% x Equipment and Materials Inflation + 40% x Labour Cost Inflation

Tender Index Forecast = Cost Index Forecast x Expected Change in Tender Margin

After peaking in 2018 at a rate of 7.8% our forecast is for tender inflation to moderate in 2019 & 2020 to c. 5.6% & 4.2% respectively based on the noted assumptions.

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[12] Source: https://www.independent.ie/business/personal-finance/property-mortgages/insolvencies-for-builders-up-50pc-despite-housing-crisis-37685780.html

[13] Source: www.johnsiskandson.ie

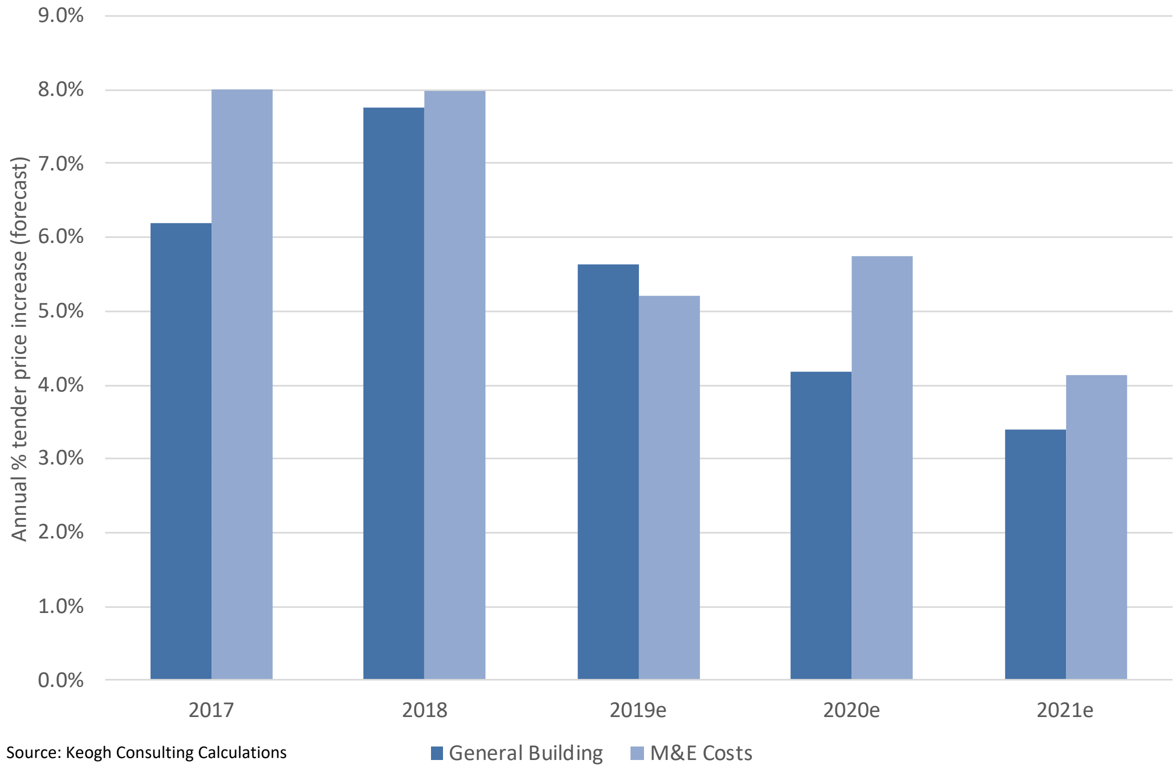

Figure 2 - Historic and Forecast Tender Prices Annual Percentage Change

2015	2016	2017	2018	2019e	2020e	2021e
3.1%	2.5%	4.2%	3.4%	3.8%	4.0%	3.4%

Table 1 – Historic and Forecast Building Cost Changes

2015	2016	2017	2018	2019e	2020e	2021e
97.4	102.1	108.5	116.9	123.5	128.7	133.0

Table 2 – Historic and Forecast Building Tender Index

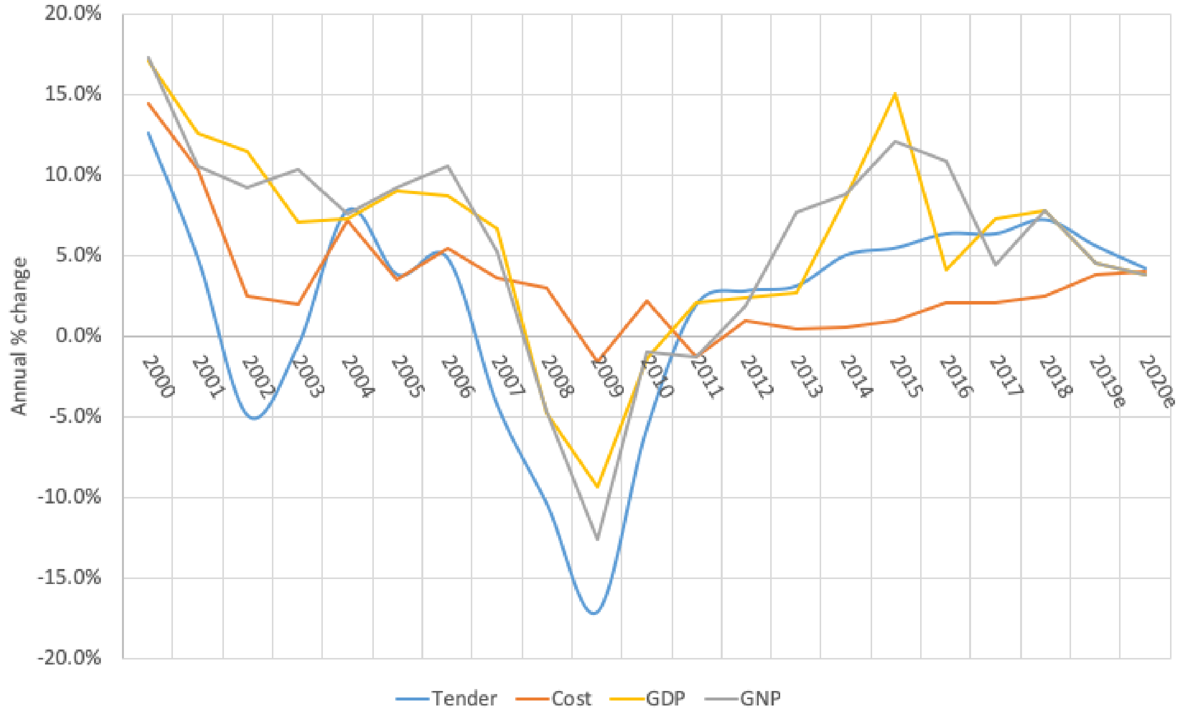

Figure 3 - Economic Growth v Tender Price Changes

Reviewing the sensitivity of tender price to changes in labour and gross margin recovery indicates that increases above 5.3% in tender prices would require a mark-up on costs increase of above 5% (from current estimated levels) and a minimum wage increase of 4% in 2019.

		Labour Cost Increase		
		2.0%	4.0%	6.0%
Mark-up on cost increase	0.0%	2.6%	3.4%	4.2%
	2.5%	3.5%	4.3%	5.1%
	5.0%	4.4%	5.3%	6.1%
	7.5%	5.4%	6.2%	7.0%
	10.0%	6.3%	7.1%	7.9%
		Estimated 2019 Tender Increase		

Table 3 - Sensitivity of Tender Prices to Wage and Margin Increases

On this basis Keogh Consulting believes that given the significant increases experienced in 2018 it is possible that price increases will moderate in 2019 & 2020.

Conclusion

Amounts provided for tender inflation should be identified separately in a budget and should be incorporated into the individual cost components at various project review stages and updated as necessary. This article has looked at the current trends in material and labour costs and, based on an assessment of the level of competition in the market, lays out a prediction for future tender inflation illustrating a clear estimation methodology. After peaking in 2018 at a rate of 7.8% our forecast is for tender inflation to moderate from 2019 on to c. 5.6% based on the key assumptions noted.

The Keogh Consulting iOS Construction Cost App can assist you in the benchmarking of the costs of your project and estimation of an initial inflation allowance based on your programme. It can be downloaded from the Apple App Store here http://bit.ly/KeoghCosts