

Trend and Outlook for Construction Tender Prices in Ireland

Recent market commentary has highlighted¹ the continued increase in tender prices in the Irish market through Q2 and Q3 and the knock-on cost impact on projects because of delays. With increases noted of 13% - 16% from early 2017 to early 2019 the tender price increase has potentially raised the forecast outturn cost of projects such as the National Maternity Hospital by €50m to €350m. The quantum of potential increase in tender prices 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 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 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 2017 it was estimated that the output of the industry was valued at €19 billion (equivalent to c. 7.9% 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 7.4% in the first quarter of 2018 when compared with the preceding period.² This reflects increases of 5.6%, 5.5% and 1.1% respectively in the volume of residential building work, non-residential building work and civil engineering work. The change in the value of building and construction in the same period was +4.4%. On an annual basis, the volume of output in building and construction increased by 20.6% in the first quarter of 2018 when compared with the fourth quarter of 2017. Output volumes increased by 30.0%, 10.1%, and 8.1% respectively in residential building work, civil engineering and non-residential building work in the year to end Quarter 1, 2018. There was an increase in 18.1% in the value of production in the same period. Based on ESRI forecasts construction output is forecast to grow to €21.5 billion in 2018 and €24.3 billion in 2019.

Construction Demand Increasing

The rate of growth in Irish construction activity has quickened in July amid widespread reports of strengthening demand³. New orders are noted to have continued to increase at a substantial pace with companies raising employment and purchasing activity accordingly. The Ulster Bank Construction Purchasing Managers' Index® (PMI®) – a seasonally adjusted index designed to track changes in total construction activity – rose to 60.7 in July from 58.4 in June. The reading signalled a fifty-ninth consecutive monthly rise in construction activity, and one that was sharper than in the previous month. Respondents pointed to increases in new work and specific strength in the housing sector. In addition, with increasing activity in the economy in general GNP is forecast to grow⁴ by +5.3% and +3.9% respectively in 2018 and 2019

¹ Source: Irish Independent 7th August. Irish Times 7th August. Sunday Times 19th August, 2018, p3.

² Source: CSO June 2018

³ Source: Ulster Bank Construction Purchasing Managers Index. August 13th, 2018.

⁴ Source: ESRI Quarterly Economic Commentary – Summer 2018.

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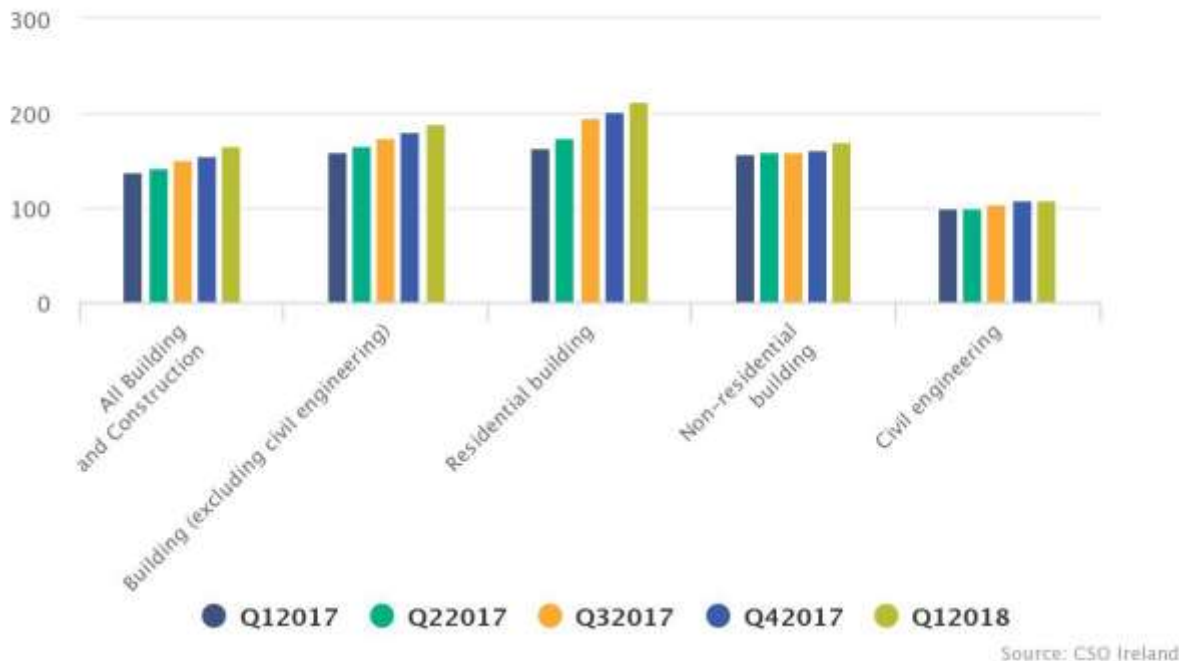


Figure 1 - Volume of Construction Production by Quarter and Type⁵

Employment increasing with labour availability and sectoral orders putting pressure on wage costs

On account of the increased activity not surprisingly CSO figures⁶ released in June 2018 shows that employment in construction has again increased 9.6% from 117.8K Q1 2017 to 129.1K Q1 2018 – still significantly below the noted peak of c. 400K in 2007. Labour costs are also increasing with the sectoral employment order giving rise to a 10% wage increase now coming 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.

Material Prices Increasing

Wholesale prices of building and construction materials⁷ have shown a price increase of 0.2% on average in June 2018. While there have been significant annual cost increases in Timber +3.95%, Steel +2.9%, Cement +3.8% and Pre-Cast Concrete +4.9%. Transport and site machinery operating costs have been impacted by a +38.9% and +11.9% annual increase in energy products and petroleum fuels respectively.

These labour and material costs, in addition to capacity constraints in the construction industry, are feeding into increased tender prices in the market as firms increase margins in the face of increasing construction demand. The increase in tender prices emphasizes the importance of providing for future construction inflation in feasibility studies and development cost planning.

Tender Forecast – Increasing through 2018 then moderation

On this basis assumptions concerning inflation over the period to 2020 have been estimated with the following assumptions:

1. The general rate of CPI inflation is forecast at 1.1% in 2019 (0.7% 2018). Thereafter it is assumed that CPI inflation is in line with the 2.0% target set by the ECB;
2. Inflation in building and construction materials is expected to rise by 4% in 2018 and then by 3% in 2019 and 2020;
3. Labour cost rise by 10% in 2018 and then by 2.5% in 2019 and 2020;
4. It is assumed that the weighted building and construction cost inflation rate will be made up of 60% materials and 40% labour costs;
5. Competitive tendering conditions.

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

⁵ Source: CSO June 2018

⁶ Source CSO: Labour Force Survey 20 June 2018.

⁷ Source: CSO August 2018

$\text{Cost Index Forecast} = 60\% \times \text{Equipment and Materials Inflation} + 40\% \times \text{Labour Cost Inflation}$

$\text{Tender Index Forecast} = \text{Cost Index Forecast} \times \text{Expected Change in Tender Margin}$

After peaking in 2018 at a rate of 7.8% our forecast is for tender inflation to moderate from 2019 on to c. 4.6% based on assumptions made.

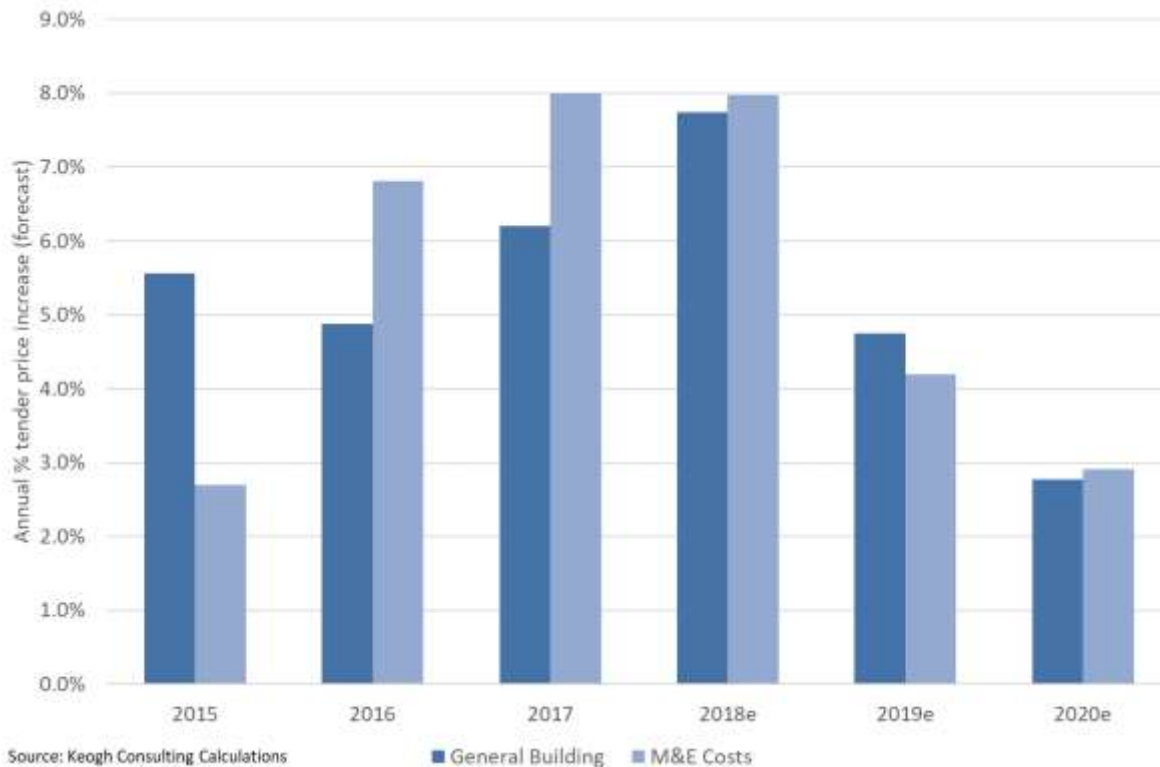


Figure 2 - Historic and Forecast Tender Prices Annual Percentage Change

2015	2016	2017	2018e	2019e	2020e
97.4	102.1	108.5	116.9	122.4	125.8

Table 1 – Historic and Forecast Building Tender Index

Examining the sensitivity of tender prices to changes in labor and margins recovery indicates that increases above 6.4% in tender prices would require a mark-up on costs increase of 10% (from current estimated levels) and a wage increase of 5% in 2019.

		Labour Cost Increase		
		0.0%	2.5%	5.0%
Mark-up on cost increase	0.0%	1.8%	2.8%	3.8%
	2.5%	2.7%	3.7%	4.7%
	5.0%	3.6%	4.6%	5.6%
	7.5%	4.4%	5.5%	6.5%
	10.0%	5.3%	6.4%	7.4%
		Estimated 2019 Tender Increase		

Table 2 - Sensitivity of Tender Prices to Wage and Margin Increases

Given the increases experienced to date in 2018 it is likely that price increases will moderate in 2019.

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. 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. 4.6% based on assumptions made.