

Trend and Outlook for Construction Tender Prices in Ireland 2020

Construction Tender prices continued to increase through 2019¹ - with increases noted of 10-12 percent from early 2018 to late 2019. The ongoing tender price increase raises the estimated outturn cost of projects in planning. Projects on site are not immune with continued cost increases on account of greater than allowed for contracted inflation provision (4 percent) being experienced on projects such as the National Children's Hospital².

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 labour 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.

Construction Market & Ireland Economy Outlook

The Irish economy looks set to register strong growth again³ in with GDP likely to increase by almost 6 percent in 2019. The economy is expected to grow by a slower rate in 2020 of 3.3 percent according to current forecasts.

The output of the Irish construction industry peaked in 2007 at over €38 billion, representing almost 24 percent of GNP. In 2019 it was estimated⁴ that the output of the industry was valued at €26.8 billion (equivalent to c. 9.75 percent of GNP) – this level is still below the sustainable European level of 10 – 12 percent of GNP.

Right sizing construction output would imply a construction output range of €28.4 - €34.0 billion⁵ in 2020.

¹ Source: SCSi

² Source: Irish Times: <https://www.irishtimes.com/news/health/chairman-of-national-children-s-hospital-gobsmacked-by-pac-questions-1.4105689>

³ Source: ESRI Quarterly Economic Commentary, Winter 2019. December 12, 2019.

⁴ Source: ESRI Quarterly Economic Commentary Winter 2019

⁵ Source: Keogh Consulting calculation based on ESRI GNP data

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Figure 1 - Trends in Construction Output Volume, Output Value, Employment v Tender Index⁶

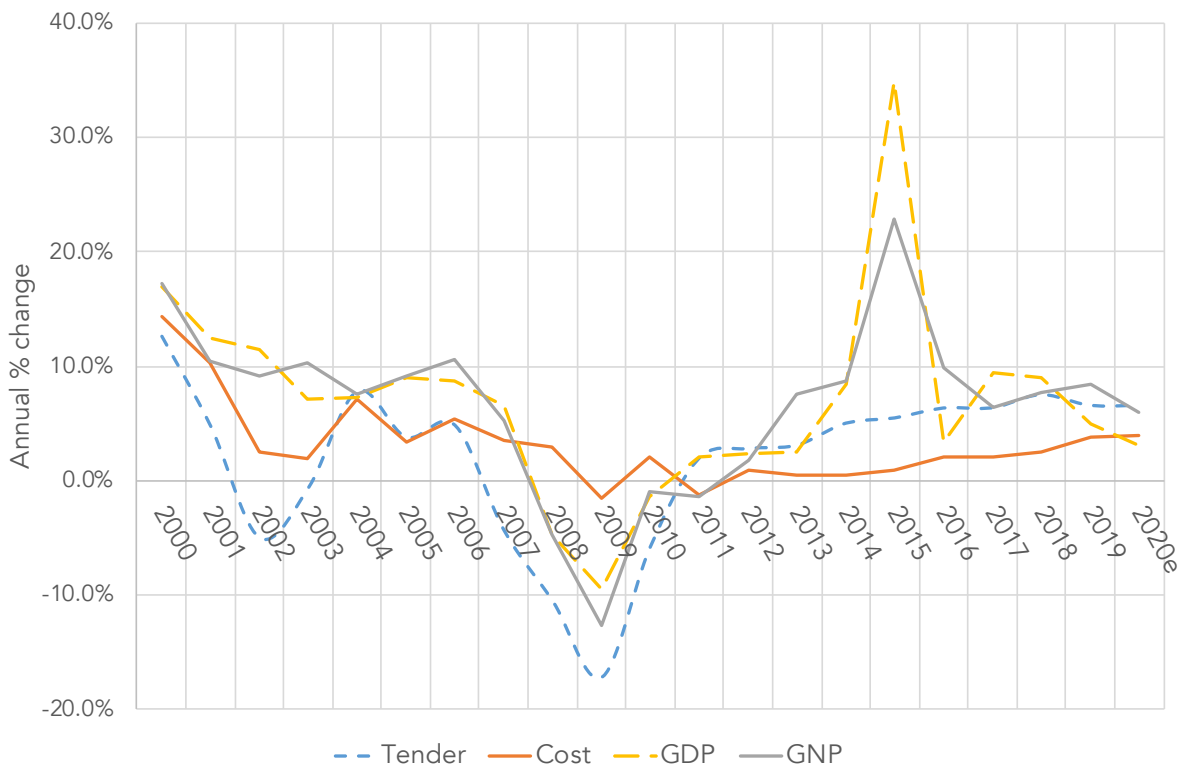


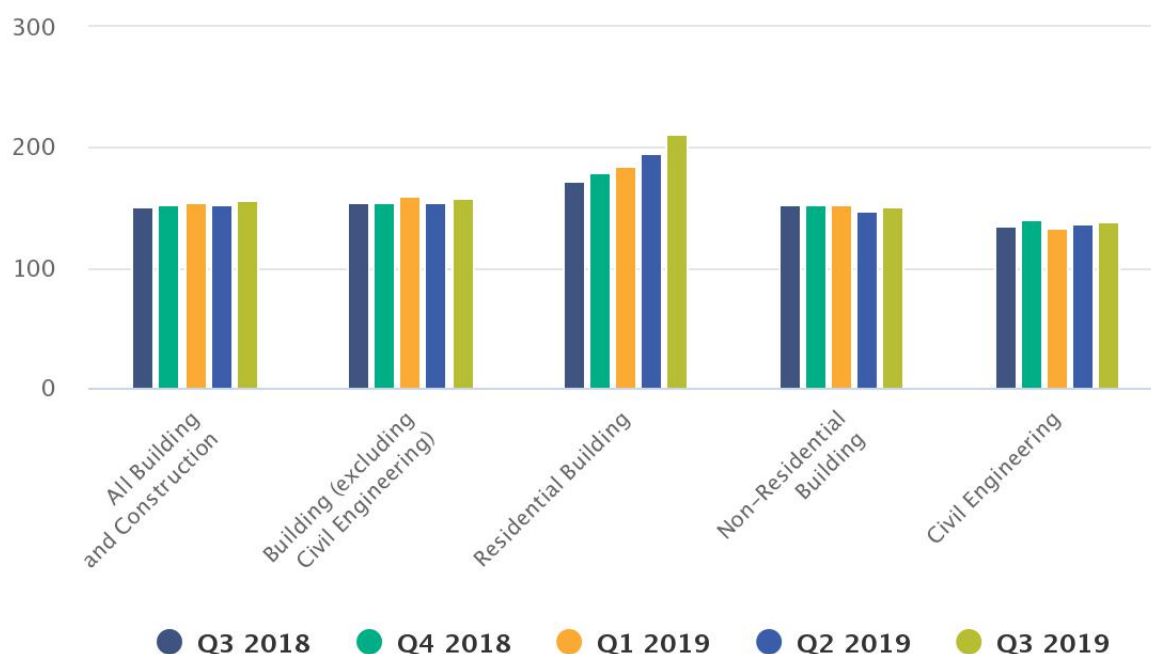
Figure 2 - Economic Growth Trend v Tender Price Changes⁷

⁶ Source: CSO statistical release, 06 December 2019, Production in Building and Construction Index. Keogh Consulting estimates of tender index.

⁷ Source: GNP, GDP - CSO. Tender, Cost Indices - Keogh Consulting

The volume of output in building and construction increased by +2.5 percent in the third quarter of 2019 when compared with the preceding period⁸. This reflects increases in the volume of output in civil engineering work +1.7 percent and non-residential building work +2.2 percent. Output in residential building work increased by +8.2 percent in the quarter. The change in the value of output in building and construction in the same period was +2.8 percent. On an annual basis, the volume of output in building and construction increased by +3.1 percent in the 12 month period to Q3 2019. There was an increase of +4.6 percent in the value of output in building and construction in the same period. This is reflective of the rising delivery cost in the market.

Based on ESRI data regarding rate of fixed capital formation⁹ Keogh Consulting estimate that construction output is forecast to grow to €29.0 billion¹⁰ in 2020 (+€2.2 billion, +8 percent) at constant prices.



Source: CSO Ireland

Figure 3 - Volume of Construction Production by Quarter and Type¹¹

Market sentiment returns to expansion

Expansion sentiment though is strong with the latest results of the Ulster Bank Construction PMI survey¹² signalled a return to expansion in Irish construction activity in December. Indeed, following a three-month sequence of falling activity, the headline PMI index rose sharply in December 2019 to get back to above the 50 breakeven level for the first time since August. Reduced Brexit uncertainty was cited as a source of support for the increase in overall activity at the end of 2019, while the improvement also reflected better performance across the three main sub-sectors. Notably, a welcome pick-up in Housing activity saw it return to expansion in December, offering some support for the view that the recent weakness in the Housing PMI was perhaps more reflective of large, adverse, Brexit-related moves in business sentiment than of marked weakness in actual underlying housing activity.

⁸ Source: CSO December 2019

⁹ Source: ESRI Quarterly Economic Commentary Winter 2019

¹⁰ Source: Keogh consulting estimate based on ESRI forecast growth in fixed capital formation of +8.3%

¹¹ Source: CSO. 6th December 2019.

¹² Source: Ulster Bank Construction PMI® Report (RoI), January 13th 2020

Commercial activity saw a further acceleration in its rate of expansion in December 2019, in the process remaining the fastest-growing sub-sector. "Overall, following disappointing readings over the previous three months, the pick-up in the December PMI is an encouraging sign that construction growth regained some growth momentum as 2019 drew to a close". However, with political and trade concerns (including China coronavirus outbreak slowing the Chinese economy) impacting on business activity globally Ireland may have to work harder to retain a flow of foreign direct investment (FDI) in a reduced size FDI pool.

Generally, public sector projects have been impacted by the overspend on the National Children's Hospital with the lack of fiscal headroom constraining the funding of new projects in many sectors. Projects that have been recently announced have been announced previously – there is currently limited growth in public spend. The February general election will give clarity and a new government with new spending policies and priorities.

Other details within the survey offered encouragement. A notable pick-up in new orders left the December reading back in positive growth territory, while respondents also indicated faster growth in demand for construction workers, with the pace of job creation rising to a six-month high in December. Moreover, the Future Activity Index rose to a six-month high in December, as confidence about the sector's future prospects is being underpinned by expectations for availability of new projects in early 2020, while reduced uncertainty around Brexit was also cited as a source of support for the outlook. However, the previous trend¹³ in the overall Construction PMI may point to downside risks to the construction outlook as 2020 approaches.

Election brings uncertainty

However, the general election called for February 8th may give rise to uncertainty and unintended consequences in the construction market as we wait and see who gains power and what policies are put in place – particularly in relation to the residential sector – some of the solutions being proposed across the political parties are likely, at best, to have no beneficial impact. And some of them may make things worse.

Supply Chain Profitability & Competition.

The top 10 contracting organisations typically achieve an average pre-tax profit margin of 2-3% (Sisk – 2017 2.8%, 2018 2.4%¹⁴, Walls – 2017 2.15%, 2018 2.56%). 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.

Given these risks and market conditions, 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 as illustrated by several contractors reporting reduced turnover but increased net pre-tax profits.

While current commercial activity levels within the M50 are high, as indicated by the number of cranes and active construction sites, the start date of some new projects has been pushed out of with some firms now

¹³ Source: Ulster Bank Construction PMI® Report (Rol), December 9th, 2019.

¹⁴ Source: www.johnsiskandson.ie

having capacity in their pipeline for a 2020 start on site. Any delays in converting pipeline into turnover mean that contractors, may need to bid for more work. This is increasing competitive pressure in some sectors and project sizes. This trend is highly sector specific with some markets, such as data centres, being very busy.

Material Prices Increasing

Material prices are increasing with the wholesale prices of building and construction materials¹⁵ have shown an annual price increase of 1.6% on average in the 12-month period to December 2019. Transport and site machinery operating costs have been relatively flat with a slight increase in petrol, and diesel costs. Wholesale electricity costs have fallen by c.21% in 2019.

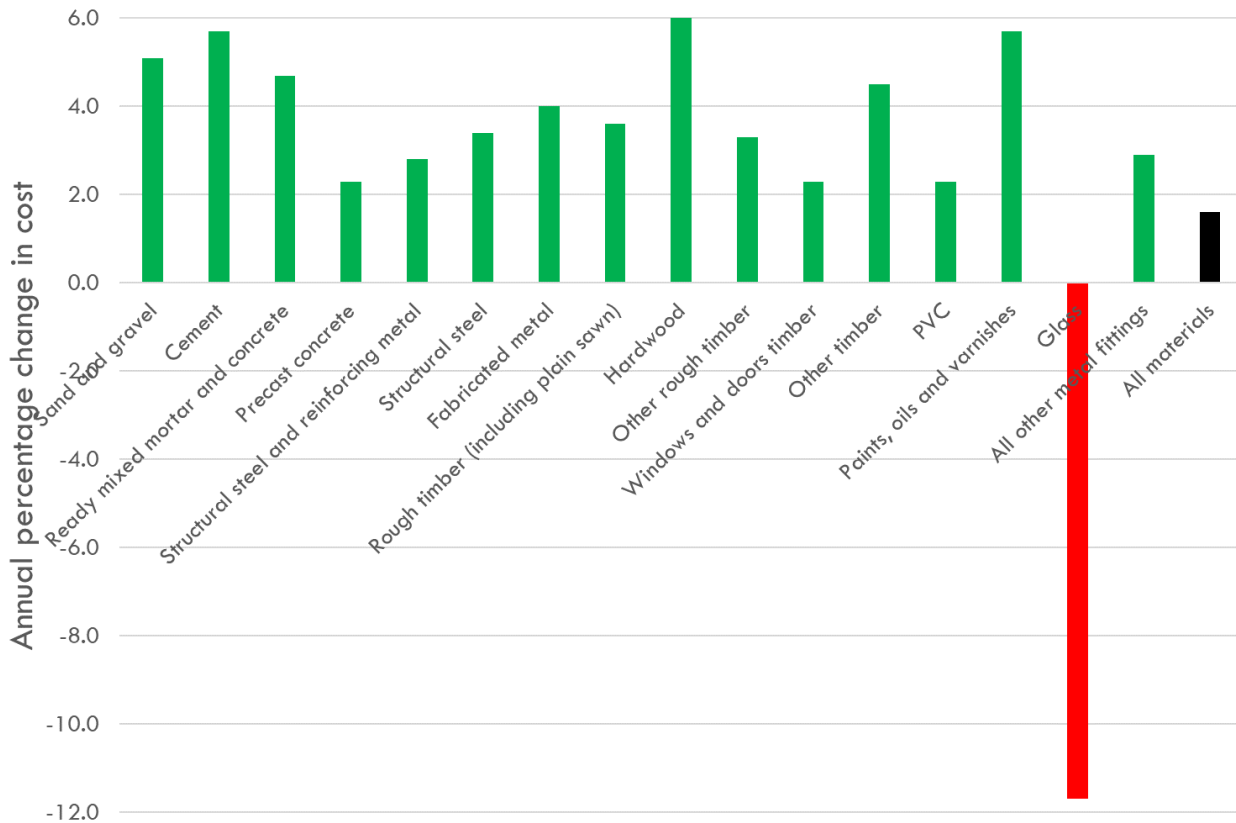


Figure 4 - Wholesale Construction material Changes 2020

Due to significant dependency on imports any imposition of tariffs or currency movements following Brexit will lead to an increase in material costs – however, early negotiating positions laid out would seem to indicate that this would not end up being the case. The overall outlook for material costs is inflationary as with material costs being expected to rise on the back of strengthening sterling euro exchange rates and increases in energy prices¹⁶. There have been widespread reports of greater raw material prices (notably steel, insulation and fuel), with a consequent sharp rise in input costs during November.

¹⁵ Source: CSO December 2019

¹⁶On the demand side, oil prices have been kept subdued due to the ongoing trade war between the US and China. Any escalation in trade tensions is likely to see a slowdown in economic activity which in turn will lead to a downturn in demand for energy.

Affordability & viability impacting on residential sector despite demand

Although sentiment is improving with an increase in activity noted at the end of 2019 residential construction activity levels have moderated with residential construction not accelerating at the pace required to meet the latent demand present – residential projects are obtaining planning permission and stopping. This is backed up by the recent review of the strategic housing planning process noting that, “of the 49 SHD permissions granted between January 2018 and 30 June 2019, only 18 (37 percent) had been activated in some way, either through enabling works or commencement of housing construction.”¹⁷ Our view is that this is possibly a consequence of ongoing viability and funding issues with residential property development (despite the need for c. 30,000 new homes annually) due to an affordability ceiling and borrowing constraints.

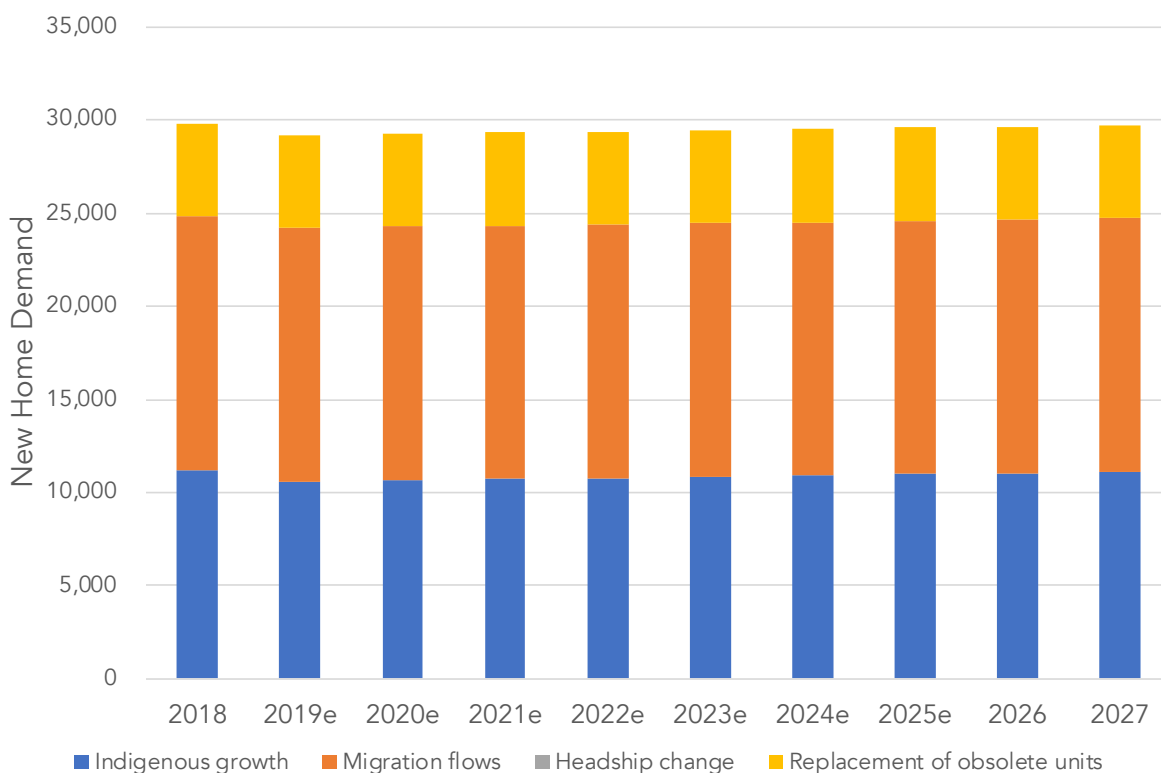


Figure 5 – Predicted Components of Housing Demand¹⁸

¹⁷Conclusions of the Minister for Housing, Planning and Local Government on the Review of the Strategic Housing Development process. October 2019.

¹⁸ Source: Keogh Consulting Estimates based on CSO data

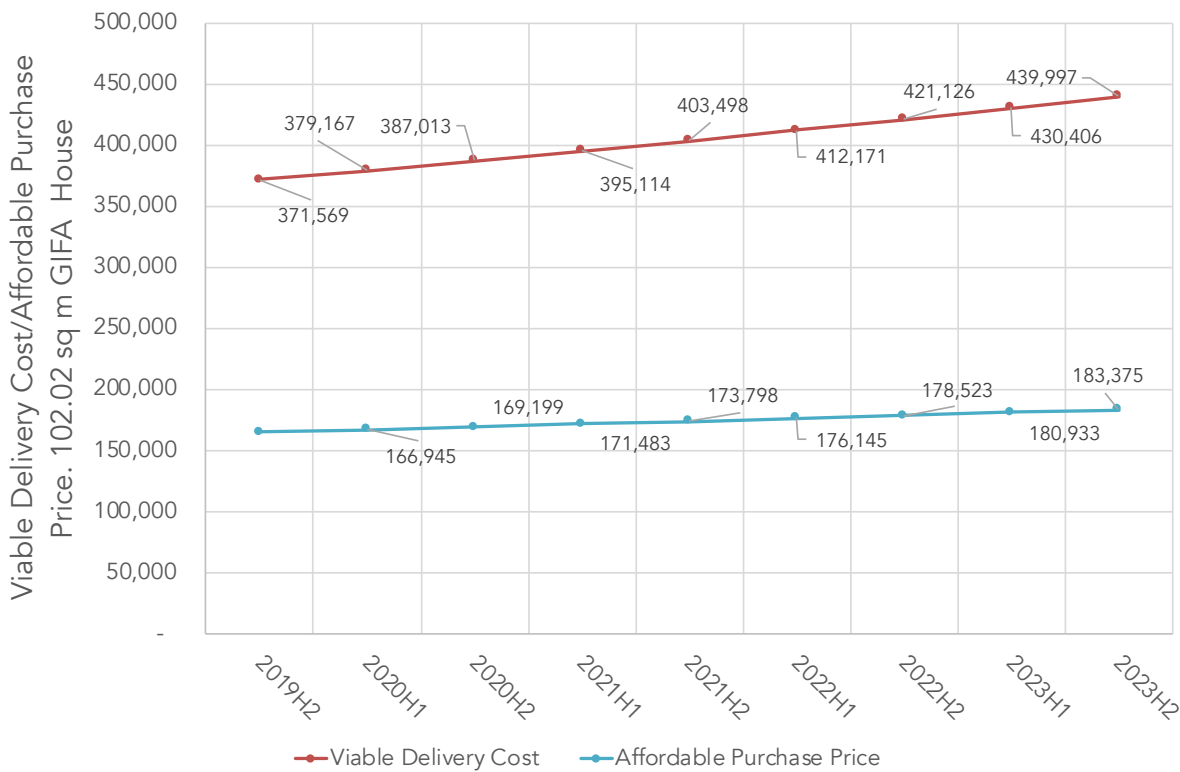


Figure 6 - Viable Delivery Cost v Affordable Purchase Price For Median Household Income

Employment growing moderately but costs increasing

On account of ongoing increased activity, CSO figures¹⁹ released in November 2019 shows that employment in construction has increased 2.0% from 147.0K Q3 2018 to 150.0K Q3 2019, still significantly below the noted peak of c. 400K in 2007.

Output per construction worker has stayed broadly within the range indicated below with minimal productivity gains since the construction market peak in 2007. This would imply an extra 10,000 – 14,000 workers being required to meet the expected £2.2 billion growth in output in 2020.

There are large projects starting in 2020 – the massive Intel Fab project will absorb a large amount of industry capacity with the two planning permissions representing a \$8 billion (£7.26 billion) investment which is estimated to employ 6,000 construction workers (4 percent of total construction employment) at peak and 1,600 full-time jobs on completion. It may be that there is a like for like replacement of industrial capacity given the completion and commissioning of some recent industrial projects including a number of data centres and pharmaceutical plants.

Labour costs are rising with the 2018 & 2019 sectoral employment order feeding labour cost inflation – the October 2019 SEO will increase costs on the back of the +2.7 percent wage increase and an increase in the working week from 37 to 39 hours. We estimate that this will give rise to a base 5.2 – 7.7 percent increase in labour costs.

¹⁹ Source CSO: Labour Force Survey November 2018.

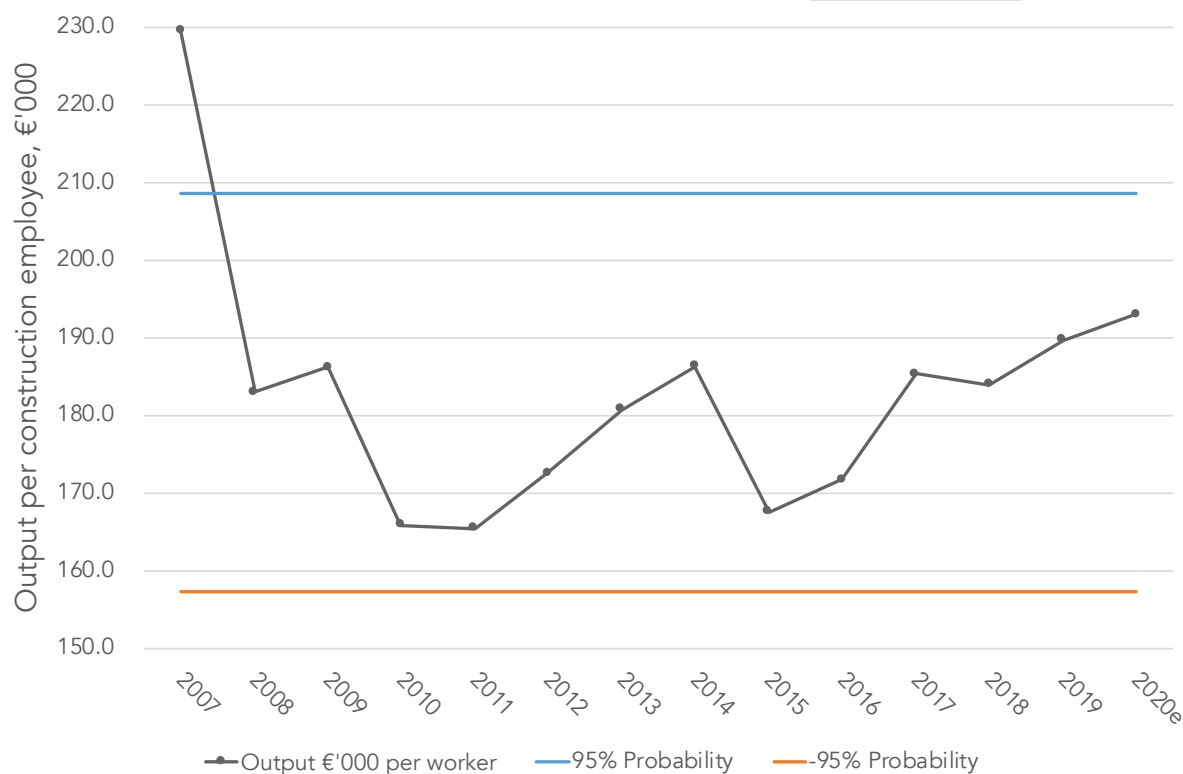


Figure 7 - Construction Output per Worker at Fixed Price²⁰

Prices to increase through 2020

Our view is that there will be some further increase in tender prices in 2020 as contractors look to selectively tender and cover the costs of rising labour and materials prices. 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 GNP growth in Ireland of +3.3 percent in 2020²¹ moderating from +6.0 percent in 2019. +€2.2 billion in construction output.
2. The general rate of CPI inflation forecast at 1.0 percent in 2020 (0.5 percent 2019) and 1.2 percent in 2021. Thereafter it is assumed that CPI inflation is in line with the 2.0 percent ECB target;
3. Inflation in building and construction materials rises by +3.0 percent in 2020 and 2021, unwinding some of the material price reduction experienced at the end of 2018;
4. Average labour costs rise by +6.0 percent in 2020 and then by +4.0 percent in 2021 and 2022;
5. It is assumed that the weighted building and construction cost inflation rate is made up of 60 percent materials and 40 percent labour costs. 30 percent M&E in building²²;
6. Competitive tendering of projects.

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

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

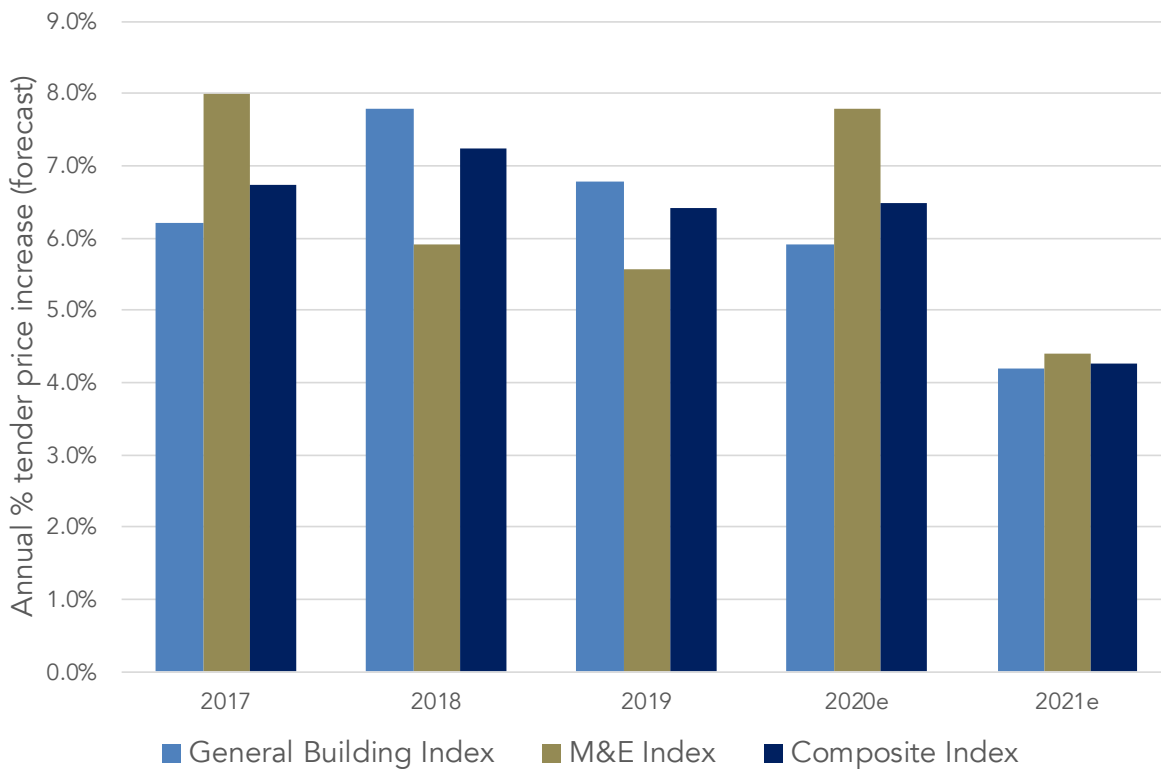
²⁰ Source: Keogh Consulting Calculations From CSO data.

²¹ Source: Quarterly Economic Commentary Winter 2019, ESRI, 4th December, 2019

²² Buildings with a higher/lower M&E percent may vary from the noted tender increase

2. Tender Index Forecast = Cost Index Forecast x Expected Change in Tender Margin
3. Average M&E cost at 30% of Total Building Cost

After peaking in 2018 at a rate of 7.2 percent our forecast is for tender inflation to moderate in 2019 & 2020 to c. 6.5 percent & 4.2 percent respectively based on the noted assumptions.



Source: Keogh Consulting Calculations

Figure 8 - Historic and Forecast Tender Prices Annual Percentage Change

2015	2016	2017	2018	2019e	2020e	2021e
3.1%	2.5%	4.2%	3.4%	3.6%	4.2%	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	124.9	132.3	137.8

Table 2 – Historic and Forecast Building Tender Index

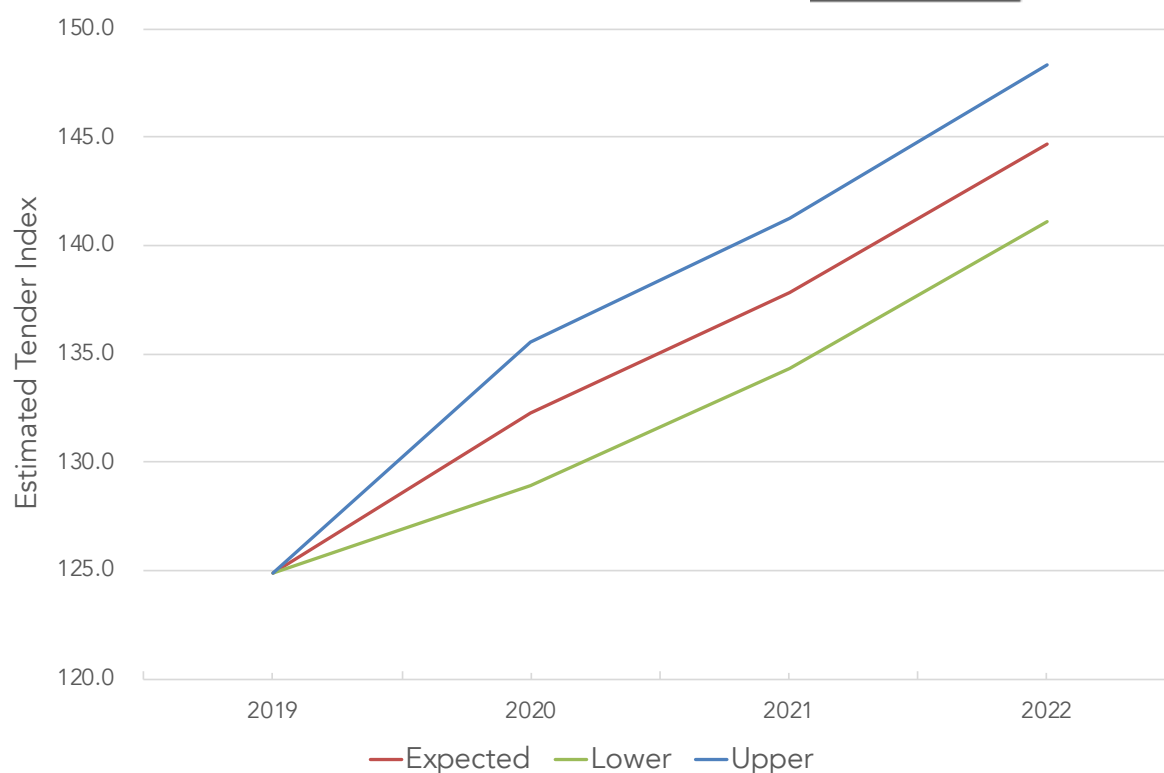


Figure 9 - Forecast Tender Index Ranges

Reviewing the sensitivity of tender price to changes in labour and gross margin recovery indicates that increases above 6.5 percent in tender prices would necessitate a mark-up on costs increase of above 2.5 percent (from current estimated levels) and a minimum wage increase of 6.0 percent in 2020.

Labour Cost Increase				
		+5.0%	+6.0%	+7.0%
Mark-up on cost increase	- 5.0%	4.0%	4.4%	4.8%
	- 2.5%	5.0%	5.4%	5.9%
	0.0%	6.1%	6.5%	6.9%
	+2.5%	7.1%	7.5%	7.9%
	+5.0%	8.1%	8.5%	9.0%
Estimated 2020 Tender Increase				

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

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 7.2 percent our forecast is for tender inflation to increase by 6.5 percent in 2020 based on the key assumptions noted.