



Costs fall by 10%

"By the end of the calendar year 2009 we will have seen construction costs fall by up to 10%", says David Mitchell, Director of Mitchell Brandtman Quantity Surveyors. "However, be aware of the sting in the tail and don't expect historical performance to be a good indicator of the actions of construction costs this time around".

The sub-prime crisis has tightened availability of credit and driven increases in the cost of capital. The mix of higher borrowing costs, more conservative lending practices, and financial institutions reducing their exposure to commercial property has seen a rapid decline in funds available to be lent for development.

This, coupled with general uncertainty, has initiated a decline in projects coming on line and has resulted in downward pressure on construction costs. Furthermore, negative sentiment and fear have led to increases in competition amongst contractors for forward work and this has resulted in price cuts and 'buying work'.

According to David, "the current falls in construction costs will be the greatest decline since the early 1990's when we saw -9.9% and -8.4% in 1990 and 1991 respectively". While there is some retrospective debate among QS firms about whether the fall began in the last quarter of 2008 or the first quarter of 2009, there is general agreement that the decline will continue through until the beginning of 2010, with a flattening by mid-year leading to modest CPI style increases by 2011.

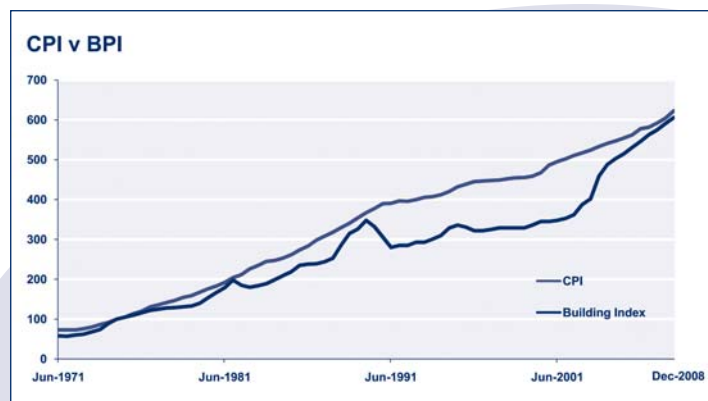
Most experts are basing their projections on historical trends. However, while there are some similarities to previous troughs in the market, there are critical differences that have the potential to change the dynamics of the cycle.

A defining characteristic of the decline in 1991 was 'over supply' and this played a large part in why construction costs took almost 10 years to recover to their previous highs. Whilst

demand is currently dropping, it is not as a result of speculative construction and being 'over built'. This will change the dynamic of the recovery cycle and increase the possibility of an upswing in construction costs that could well be swifter and sharper than the slow creep experienced from 1992-2002.

An additional driver for a strong upswing is the underlying demand. Lower construction costs combined with government stimulus, lower interest rates, and reduced dwelling sizes will have positive impacts on affordability and create a sustained demand for construction.

As can be seen by a comparison of the Building Price Index and CPI, each time the BPI has been about to hit the long term CPI, building prices have fallen. In 1981 it took 5 years to recover and in 1992 it was almost 10 years. The critical period in this cycle will be within two years of the recovery and the leading indicator will be a spike in residential sales. Most people expect this to be mid 2010, so position yourself for strong cost growth in projects



commencing 2012/2013.

Points to consider

The projected falls will not be equal in timing or weighting across industry sectors and construction types.

Sectors that have higher barriers to entry, require highly specialised skills, or have a long forward work book will see price stability in the short term – while simpler and more accessible projects will face increased competition.

Increased competition will result in contractors 'buying work'. The temptation will be there for developers and contractors to take advantage of the lowest tender result regardless of existing relationships. However, care must be taken to manage the additional risks of time blow-outs, increases in the cost of variations, and disputes.

The material in this bulletin is for general comment only. For further information contact **David Mitchell** on **07 3327 5000**. If you would prefer to receive our bulletin via email, or do not wish to receive our information in future, please email **Lisa Veneran**, Marketing Manager at **lveneran@mitbrand.com**



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