COVID-19 and the New Zealand Construction Market

April 2, 2020

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Abstract

In this paper, authors Simon Barnes, Scott Beagley, David Doherr, Craig Weston and Robyn Montgomery look at the impact of COVID-19 on construction market in New Zealand. It is important to note that current conditions are changing quickly; this paper was based on information available as of April 2, 2020.

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COVID-19 – What Do We Know So Far?

The novel coronavirus, COVID-19, is a global pandemic which has now proven itself to be a serious threat not only to public health, but also to the global economy.

New Zealand is in a national state of emergency and at Alert level 4. Lockdown will last for at least 4-weeks.

*The national state of emergency has been officially extended.

As of 26 March 2020, only essential business in the Building and Construction sector is allowed to continue to operate.

Key Highlights to Date

- Although there is a global recession on the horizon, we do not expect that the construction labour force can contract near the same the GFC levels as 2009.
- On the supply side, China's initial response to the outbreak included shutting factories and ports, which severely disrupted global supply.
- The economic slowdown caused by the outbreak is expected to have the effect of dropping prices for many construction materials.
- Material pricing is expected to fluctuate over the coming months/years, driven by supply and demand.
- Production in China is currently almost back at capacity; as a result, we expect to see materials and products such as steel, aluminium joinery, lighting and FF&E (Hotels) being provided at a reasonable cost.
- Airlines, tourism and accommodation sectors have been hit the hardest, with some seeing a suspension of revenue activities, which in turn is expected to affect project funding. We note a number of hotels are being "mothballed" for up to 6-months.
- Projects that are partway through are expected to continue to completion, but new projects are likely to slow down and potentially be placed on 'hold' in the short term.
- Despite uncertain market conditions, design teams have moved to "virtual offices" and continue to design, essential infrastructure and services sites remaining active and open, and clients are still looking to future projects - all of which shows that the construction pipeline is still flowing. We are seeing larger contractors taking advantage of the opportunity to get on top of paperwork with senior site staff still processing information requests.

Impact on Construction Sector

- Wage reductions are likely within the industry as high price areas such as Queenstown see a drop in activity and labour flows back to the traditional larger centres.
- Greater labour forces concentrated in the key centres competing for less work will likely reduce pricing.
- Immigrant workers on large scale projects such as the SkyCity Convention Centre and Transmission Gully motorway won't be available to return for some time therefore will impact the restart of some projects.
- Pre-lock down temporary labour companies in Christchurch were noticing a slowdown in placements.
- Unlike the earthquakes when demand grew rapidly requiring additional labour, the demand is now drastically reduced in the short to medium terms.
- The supply chain for materials is currently intact and reports are that overseas imports from places such as China are returning to normal levels.
- Good communication and planning will be key to an efficient and effective commencement on site following the lock down.
- IT systems available in 2020 are a vast improvement on that available in 2010 during the first quakes and will enable the Contractors admin tasks to continue and in most instances get on top of variation pricing.
- Funding is expected to restrict new developments, with return on investment numbers not hitting expected levels in current market conditions. Those with available funds, strong track records, and a past record of success will be preparing to invest when the market is at its lowest.
- New lenders, have been expanding their activities in New Zealand over the past year, they are now expected to be pulling back. This will reduce availability of finance that will affect some development projects.
- Banks will be concentrating on servicing existing clients.
- Banks are expected to withdraw from funding new development projects for at least the coming year due to risks associated with pre-sales and deposit loss.
- Auckland and Queenstown have been the most affected, with airport, retail and hospitality new start projects hit the hardest. Domestic tourism is however expected to partially soften the blow for operators in these locations while border restrictions remain in place.
- The COVID-19 situation remains highly dynamic and difficult to predict beyond the near-term. Current signs point to things getting worse before they get better, both for the construction industry and the economy as a whole.

Insurances - Project Sites Will Be Covered

While project sites fall silent during this shutdown period insurance companies have confirmed that customer's projects are covered during this uncertain period and that they "we will not be applying exclusion for losses directly caused by construction work being required to stop at project sites solely due to the government ordered lockdown due to COVID-19 threat level four". Customers however are still required to take all reasonable care to protect their works and should take all reasonable precautions to protect and lock up their sites, removing valuable items or equipment where they can.

*Please check with your insurance broker.

Escalation

Understandably, many people have questions about the impacts that COVID-19 will have on escalation. Ultimately, time will tell, but in the short-term we expect labour to catch up to volume demands. We also expect this to change once projects come back online and the virus dissipates, at which point there will be a surge of demand for the workforce.

Material prices in general are expected to bounce around before levelling out towards the end of the year. It is reasonable to expect a similar pattern of activity with imports as China's production facilities are coming back online. All told, we are expecting escalation to reduce to zero in New Zealand for the remainder of the year and into 2021.

For 2022 onwards the market may well enter a period of stagflation or even de-escalation. Historically construction costs fall during a recession consequent of the Global Financial Crisis the New Zealand construction market cost index fell over 20% in 1-year with contractors and subcontractors pricing work at very small margins to remain competitive.

Contractor Feedback …

Some Contractors are already making staff redundant due to projects being put on hold.

There is a general nerviness about the subcontractor's ability to keep staff if the delay drags on too long.

Most contractors have taken advantage of the government employer wage subsidy scheme which will reduce the cost of the delay.

It is expected that it will take time to get jobs going again once alert level 4 is lifted. Concrete supply is expected to become a bottle neck when the jobs restart.

Concern over the resources available from subcontractors when the restart happens due to potential layoffs.

Concern over the availability of migrant workers who are involved in many projects. We know some have decided to stay in NZ during this time but others have gone home.

Not too much concern over the availability of materials from China as they appear to be back at full production.

Most main contractors are willing to cooperate with negotiating terms for the stoppage period with the general feedback being that they acknowledge that this is a time to cooperate and provide transparency over real costs for the delay.

Contractors are trying to negotiate deals with plant suppliers to get plant and scaffolding off hire during the delay period or negotiate deals that will reduce the hire costs.

Most contractors are using this time to get the paperwork on projects up to date.

Most contractors are aware that COVID-19 is going to create a significant impact on the industry for some time.

Impact of Shutdown – Extension of Time

COVID-19 alert level 4 shutdown is an unprecedented action that was totally unforeseen by all parties at the time of entering into contracts and therefore we will have to work together to mitigate the impact on the project.

There has been considerable dialogue over the last week amongst industry advisors, consultants, lawyers and contractors on how to fairly deal with this delay

COVID-19 is not due to a fault on the part of the Contractor nor the Principal and needs to be treated and managed by all parties as an unforeseen event.

In a NZS3910/3916:2013 contract a delay to the critical path works arising out of COVID-19 alert level 4 could not have been reasonably foreseeable by an experienced contractor at the time of tendering; therefore the most appropriate provision for dealing with such delay would be clause 10.3.1(f). Which grants an extension of time.

Contractors have been requesting the Engineer to the Contract (ETC) to issue a suspension instruction under clause 6.7. We have noticed that government agencies and departments have been issuing suspension notices and concessions such as returning retentions and relaxing bonding provisions, we understand that one of the drivers is that the Government doesn't want be seen to be disadvantaging the contractors. It may well also be politically driven.

In the private sector, the legal advice to ETCs was that a suspension wasn't necessary as the government order was in effect a suspension for the period of the shutdown.

The legal advice provided to contractors is that the Engineer must issue a suspension notice or instruction. To our knowledge to date most ETCs on the larger scale projects have not yet issued suspension notices, however we understand that the legal advice now being provided is that it is in the interests of both the Contractor and Principal to negotiate a suspension on terms acceptable to each party.

It appears the objection to issuing a suspension under clause 6.7 was the fact that it entitles a contractor to a variation under clause 6.7.3 and therefore all the variation provisions included in clause 9 would prevail. This isn't seen as equitable in these circumstances. In addition to this clause 6.7.4 would entitle the contractor to request the uncompleted works be deleted from the contract after a delay of 4 months. This is seen as a principal risk that should be avoided in the circumstances.

There is also an argument as to whether the contractor is entitled to a variation under clause 5.11.1 of NZS3910/3916:2013.

Based on the above and should common sense prevail we anticipate that on NZS 3910 / 3916:2013 contracts that the Principal and the Contractors will agree to reasonable terms to suspend the works in accordance with clause 6.7.5. It is anticipated that the Contractor will make all reasonable steps to minimise the costs associated with this delay. The Government has stated that they will assist the industry by providing financial assistance and we understand that most contractors have taken advantage of this offer and will also negotiate terms with suppliers and subcontractors which will reduce the impact on them and the Principal.

The Fitout Future…

Immediate from the market reactions was the 'hold' and occasional cancellation of new fitouts.

Buoyed by rental 'freezes' on existing leases during the alert level 4 shutdown, foreign entities and more obviously those in entertainment, hospitality and retail have put their fitout projects on ice to take stock and wait for post-COVID-19 to better understand what their business may look like, in terms of size and in what new ways of working might be.

Having all staff now forced to operate from remote locations are business noticing a drop in efficiencies or an uptake of flexibility? Will they swing back towards enhancing and encouraging their 'in office neighbourhoods', bump zones and collaboration zones? Or will they support and foster more remote working independent of office teams, flexible IT solutions and a move away from 1:8 utilisations?

Will they need or want the same expensive NLA as they previously thought?

Significant new office stock in downtown Auckland is due to come onto the market over the coming year and while the ink may have dried on many of the ATLs covering most of the NLA, these base build projects themselves now face delays and property owners and developers will need to communicate regularly, constructively and transparently with prospective tenants to ensure their knock on effects to fitout project costs, program, lease tails etc are minimised.

Post COVID-19 may see landlords stretching to offer incentives to fill their stock, but this will be met with a slow tenant market nervous to spend large capex in an uncertain future.

While low interest rates, government compensation, changes to tax, insurances policies and many more avenues will assist, both sides of the spectrum are under adverse conditions.

There are more questions than answers at this time. Clients should seek legal and leasing agent advice regarding specific situations and consider both their immediate and long term arrangements.

These are unprecedented and changing times we are utilising our many years of experience to interpret what is happening to assess the potential risks and provide the best advice to our clients.

What We Can Do –

Things to Consider

Suggestions to assist with the construction sector cashflow challenges faced by this lock down could be:

- Reduce the progress payment claim cycle to 2-week intervals and ensure if a drawdown funding process is in place that this occurs promptly each cycle.

- Reduce the bond values on existing projects to 5% of Work to Complete. This will free up capital held against bonds and / or securities over which further lending could be secured.

- Where there is no bond a sliding scale of retention release could be considered, maybe for the likes of earthworks and reinforcing steel, trades which the Main Contractor typically does not hold retentions anyway and is funding the retention held by the Principal for these trades.

These suggestions could all be seen as counterintuitive to a Client or funder. In these uncertain times it would be argued that the Client requires more security, not less. But the survival of the Contractor / Subbie / Supplier is the key to getting projects completed now and into the future. If a Contractor can offer a payment to a subbie every 2 weeks, the subbie will be more motivated to go to his site rather than one where he waits for another 6 weeks. And he is more likely to stay in business to complete the project.

The Prime Minister said…

Industry leaders had been asked to find infrastructure projects that are ready to start as soon as possible.

Work is underway to speed up consents for the development of infrastructure projects during the recovery from COVID-19 to provide jobs and stimulate our economy.

Advance payments would be made to some employers to hire staff so that work could begin as soon as possible.

bbd Team

Our great team remains fully operational with remote working and business continuity plans in place (as a direct consequence of learnings from the Christchurch Earthquakes). If we can support you in any way, please get in touch.

Watch this space for bbd's new 32 recently opened office locations…

Simon Barnes

Simon has over 40 years' experience and expertise is recognised in the industry and he is utilised extensively to negotiate contracts and provide expert opinions on a wide range of projects.

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Scott Beagley

Scott has extensive and specialist expertise across a wide range of development projects in providing Project Finance Services, acting for Banks and Financial Institutions, Initial Project Review Reports, Drawdown Valuation, Cost Management, Engineer to the Contract and Feasibility services.

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David has over 30 years' experience in the construction industry. His experience includes all aspects of quantity surveying, cost planning, cost modelling and contract advising.

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Craig has 25 years of year's experience as a QS in the construction industry here in New Zealand. He has worked for professional firms, contractors and subcontractors and specialises in estimating and construction procurement.

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Robyn Montgomery

Over 20 years in the industry, both in New Zealand and overseas, has given Robyn experience in all aspects of a Quantity Surveying role. She has cost managed many significant projects across numerous sectors.

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