111 Pine Street
Suite 1315
San Francisco
CA 94111

415 981 9430
415 981 9434 fax
info@tbdconsultants.com

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California Current Market Conditions – March 2019

In July 2018 we were reviewing when this current cycle of expanded construction activity would start to lose momentum.

In the last two quarters of 2018, the combined political and economic turmoil set the scene for a stock market in wild gyrations mostly on the downside.

There was a real threat of the tariff war and counter tariffs would have a major impact on economic activity with the construction market stuck in the bullseye especially with regards to steel, aluminum and timber.

However, in the first two months of 2019 we witnessed a dramatic turn up for the stock market (getting back closer to all-time highs with the best first two months of the year in the last 28 years) and optimism that the tariffs war with China may get resolved. The picture going forward is far from clear but at least there is optimism that the economic climate may stabilize and avoid a downturn in confidence factors.

In nationwide surveys seeking out construction professionals to forecast the market in next two years the consensus was a probable cooling off and softening of the construction market albeit that this would not occur until mid to late 2020.

Regarding steel tariffs: It should be noted the tariffs are only on milled steel. Fabricated steel products are not facing penalties and fabricators in other countries are taking advantage of this loophole (especially Canada and Mexico).

The current California construction market remains buoyant especially the Bay Area, with design professionals and contractors actively seeking staff at all levels. This inevitably has translated into pay hikes to hold or attract new staff.

The current factors that continue to drive the construction market:

1) Projects are getting bigger and bigger with some mega projects underway e.g. $2 Billion LA Airport expansion.

2) Education is a very hot market with many school bonding programs underway.

3) Technology sector clients are pushing ahead with major projects to house staff.

4) Lack of competition especially at the subtrade level. Finding two or more competitive bidders for each sub-trade is a critical ongoing problem.

5) Lump Sum Bidding: Many major General Contractors can avoid the vagaries of lump sum bidding by focusing on negotiated projects. This leaves a smaller pool of GC'S willing to bid on Lump Sum Projects.

6) Lack of experienced construction personnel is an ongoing problem. The problem is endemic in the US and solutions are needed long term.

7) Schedules: In this market it will be difficult to work to tight schedules. With Subcontractors at capacity and juggling many projects, you can expect extended durations or delay.

8) Public sector projects: The Lump sum bidding sector can expect a relatively small number of bids even on new projects. Clients will need to work harder and harder and spend more time to attract responsive bidders.

9) Housing: The cost of renting or buying is a major impediment to attracting or retaining staff. Living in the outer periphery of the Urban Areas and commuting is not attractive either given the extended commute time and traffic congestion.

10) Material Costs: There is still a strong demand for all construction materials, accordingly we see material prices rising although the market should be more stable than 2018, where tariffs sent shock waves into the market.

11) Modular Construction: The interest in Modular construction dominated some headlines in 2018. The high cost of site labor should make many housing projects good candidates for modular construction and certain developers and clients are forging ahead with modular projects. Although Modular construction has been around for some time, developers and contractors are finally becoming more comfortable with the risks of off-site modular fabrication and navigating the potential on site union issues.

12) Financing: Some projects are subject to financing from overseas. These projects may see some delays as the economy in those originating countries is much less certain and funding may be revised to reflect this greater uncertainty.

Other factors that could have an effect on the construction market:

1) Infrastructure: There is a reasonable chance the federal government will pass a major Infrastructure funding bill. This would inject capital into a significant number of projects.

2) Sticker shock: On certain projects the sticker shock has caused clients to pause and change direction, this may happen more frequently. Value engineering or re-bidding projects may be required to move projects forward.

Escalation and TBD Index

The TBD index is published on our website, www.tbdconsultants.com, and monitors the in-place construction cost escalation for a simple new construction building.

Our TBD Cost Index has shown an escalation rate of 96 % since the first quarter of 2010 through last quarter of 2018 - that equates to an average annual escalation of approximately 7.75% compounded over the last nine years. For the year ending last quarter 2018 we have assessed an escalation rate of 9.25% compared with the last quarter of 2017.

This compares with historical escalation, (before the current expansion), in the 3.5% - 3.75% range.

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Bidding Contingency

The heated market of previous years continued throughout 2018 and into 2019 with bid results reflecting this heavily impacted market.

The subtrade responses vary from job to job, but in many cases, there may be only one responsive bid on selected trades. If this is a likelihood, we have been suggesting clients carry a Bidding Contingency separate from any other contingency for Design Development or Escalation Costs.

The level of Bidding Contingency recommended will vary depending on a number of risk related items. The items to be considered are as follows:

1) Public sector or Private sector
   Public sector projects carry higher risks due to more restrictive procurement methods.
2) Location of project
   Difficulty factors associated with site access, security parking etc. will attract premiums.
3) Size of project
   Small projects will struggle more than large projects to attract competitive bidding.
4) Renovation or new construction
   Renovation projects typically are less attractive and carry higher risks.
5) Project procurement methods
   Procurement methods will carry different contractual provisions and risk allocation. Projects with higher risk factors will carry premiums.

Depending on the above factors the recommended bidding contingency may vary from 0-50%. The small public sector renovation projects in difficult locations will be subject to highest risk factors.

At this stage, most public clients are aware of the current heated market and the difficulty of obtaining competitive bidding. Even if bids from General Contractors are tightly grouped there is no guarantee the response from the sub-trades was competitive in nature (or how many sub bids were received).