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California Current Market Conditions – August 2019

Our last Report in March 2019 recapped the stock market getting close to all-time highs. Come end of July 2019 the USA economy has now been growing for 121 months – (the longest run since records began in 1854) and the stock market was at an all-time high, rising 19% this year!

Familiar triggers for recession are still missing so can the good times keep moving forward? The economy has changed and so have some of the risks. These risks include global production chains and the impact of trade wars, private debt remains high, and the danger of politics impacting the monetary controls. Trade wars show no sign of abating or resolution and once again the market gyrations in early August reflect reaction to trade wars and currency fluctuations.

In the meantime, construction activity remains strong with California riding the wave of this activity. However, the problems of labor shortages are becoming more acute. Arguably the subcontractors now control most of the market and are in the driving seat. The market used to swing between feast and famine for subcontractors and their labor forces. The skilled construction force was decimated in the last recession (the number of construction workers dropped from 7.7 million to a floor of 5.5 million (according to NAIOP report) Since that time the critical need for more workers has led to rising labor rates and profit margins. (Last year however there was still less than 6 million construction workers)

The need to attract more entry level workers has been ongoing and has been difficult, currently for every four workers who leave there is only one person replacing them. As a result, the biggest risk factor for the construction industry is finding qualified and responsive bidders at the subcontractor level. Sub-contractors can pick and choose the work they want to bid on and to a large extent dictate the profit margins they are willing to work for.

Another side effect of the labor shortage is construction timelines- labor uncertainties translate to longer schedules and delays.

On the national level the large infrastructure bill has not been passed however there is some momentum from both political parties to make it happen. This could well exacerbate the labor shortages that exist.

In our recent March 2019 Report, we listed 12 items that were driving the California market. Most of these still apply and include :1) Many Mega projects underway 2) Education and Technology sectors remain hot markets 3) Lack of competition at the sub bid level 3) Procurement, methods should respond to the market (attraction of design/build) 4) Scheduling, extended timelines with impacted workforce. 5) Modular construction and the move to invoke more modular construction to save on site labor 6) Financing and the impact of cheap money and the influx of money from China- now less certain given economic climate 7) Housing- the lack of housing and the impact of rising rents – and resulting difficulty of attracting workers from outside the urban areas.

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.

Looking at the last 5 years our TBD Cost Index has shown an escalation rate of 43 % - first quarter of 2014 through first quarter 2019 - that equates to an average annual escalation of approximately 7.5% compounded over the last five years.

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

Looking forward we are anticipating escalation for the next year at approximately 5-6%, thereafter in future years the expectation is that escalation could be more subdued than the previous five years.

Bidding Contingency

In this volatile market we would still recommend carrying a Bid Contingency separate from any other contingency for Design Development or Escalation Costs. We expect the current heated market conditions to extend for at least the next 12-18 months.

The level of Bidding Contingency recommended as before will vary depending on a number of risk related items. The items to be considered remain 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).