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FTMA Trussted Insight

WHEN TIMING IS EVERYTHING

WITH TIM WOODS OF INDUSTRYEDGE

IndustryEdge™

When timing is everything

From Tim Woods at IndustryEdge

One of the ‘rules of thumb’ of Australian house building has been that it would take ‘about six months’ to build a house. The main reason that ‘rule’ has hung around so long and crossed the generations is that it was largely true, at least on average.

The recent experience has seen that rule broken, with most houses taking longer to build and some taking much longer to build.

When combined with rapidly rising interest rates – and therefore higher input costs – delays not only cost money, they cost more money than a fixed price building contract system can handle. Low builder margins – especially for some volume builders who compete for work on tight, fixed costs and often razor thin margins – have quickly been eroded by the combination of extra time to build and higher input costs.

At a national and system-wide level, the consequences of compounded time delays and cost increases has seen some builders go bust, has seen others seek to renegotiate contracts with customers, seen lenders withdraw finance and seen some buyers walk away from their deposits because of an inability to pay the mortgage on a larger loan.

Ultimately, that all means it is likely the vast pipeline of housing work – especially for free-standing houses – is nowhere near as robust and reliable as a future indicator of work available, as was once the case.

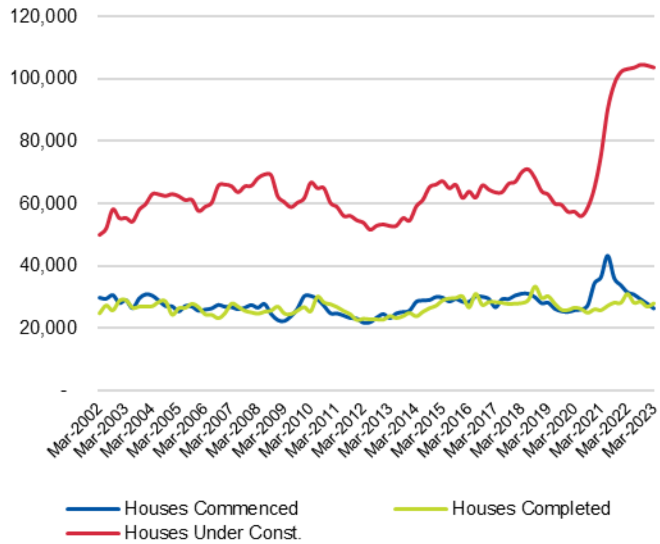
In this edition of Trussted Insight, we explore this issue further, trying to provide some guidance on the work available in the near future.

Current pipeline – taking a long time to build

Over many years, the pipeline of housing work – those ‘Under Construction’ – hovered around the 50,000 mark, gradually climbing as the nation grew its house building capacity. Since the September quarter of 1960, the average has been just under 51,000.

As the chart below shows, prior to the pandemic, in the December quarter of 2019, there were just more than 57,500 houses under construction. That was above the average, but well below the all-time peak of a little more than 71,000 recorded eighteen months earlier in the June quarter of 2018.

Pipeline of Houses Under Construction: MQ’02 – MQ’23 (Number)



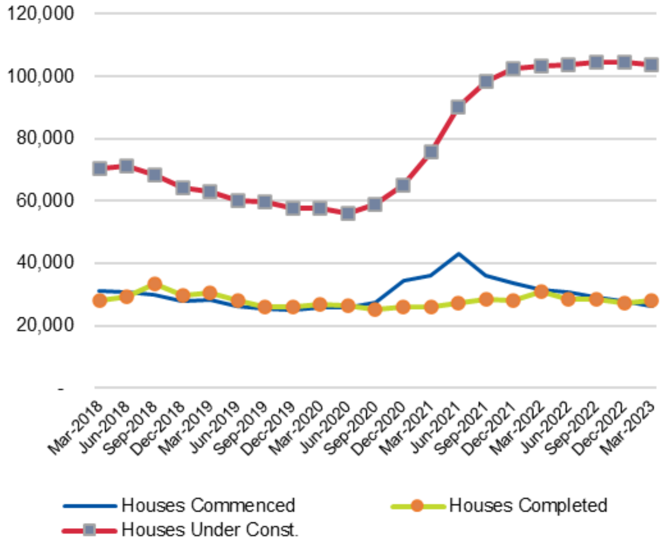
Source: ABS and IndustryEdge

This chart (previous page) has been discussed before, of course, because it shows on the red line, the huge spike in houses under construction that commenced in the September quarter of 2020. Looked at in the current light, that red line looks a little like the grainy images of the Monster popping its head above Loch Ness and is proving to be about as believable. But we'll come to that.

Meantime, we need to look at what has been the more important fact – Australia can commence as many houses as it likes, but it has never completed more than 33,400 or so, in a single quarter. That record was set back in the September quarter of 2018, as a direct response to the spike in the work under construction recorded in the previous quarter.

Below, the second chart isolates the period from 2018 to current because this period shows that even when prompted by a massive spike in work available, house completions have not increased. They have in fact, gone down.

Pipeline of Houses Under Construction: MQ'18 – MQ'23 (Number)



Source: ABS and IndustryEdge

As the chart demonstrates, from late 2020, through to about late 2021, the number of houses under construction shot into the stratosphere, but the rate of completion barely increased. That led to the amount of work lifting to an all-time high around double the long-term average. For almost two years, the amount of work in the pipeline has remained stubbornly above 100,000 houses.

Even as commencements have declined back to normal levels – because quarterly approvals have been declining – the pipeline of work has barely diminished.

The reason is simple, but the details are complex.

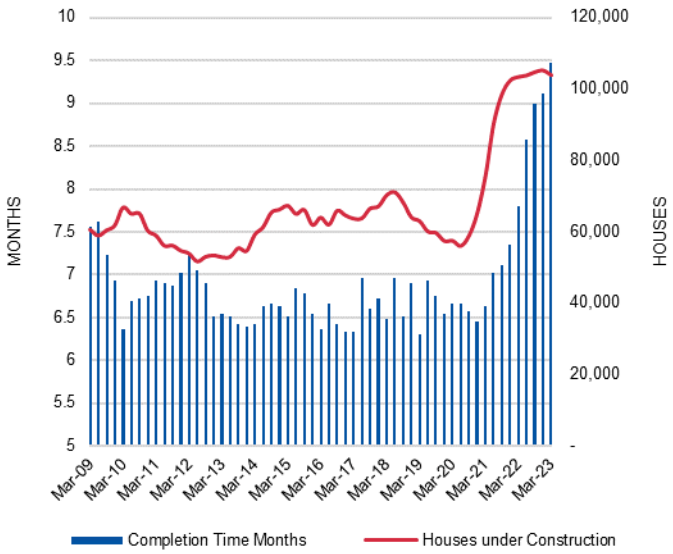
Australia's system of house building is not capable of producing more than around 30,000 houses per quarter.

When the pipeline of houses under construction shot up, much of the housing economy and supply chain considered that was good news. Fair enough because historically, a bigger pipeline would be followed by a fall in approvals, with the houses under construction acting as the buffer against a slump in work.

On orthodox thinking, if about 30,000 houses can be produced per quarter, 100,000 houses to be built would equal about 10 months of work, even if new house approvals dried up completely.

Broadly, that looks to be true, because as the chart (next page) shows, the average time to complete a house is now 9.5 months and as late as the March quarter, was still increasing! The long-term average by contrast is 6.9 months.

Houses Under Construction and House Completion Times: MQ’09 – MQ’23 (Number)



Source: ABS, Hire Thinking and IndustryEdge

While there may be a great deal of work in the pipeline, time erodes the value of that work and introduces potentially damaging variables, like, for instance, inflation and interest rate rises.

Most commentators, many fabricators and others in the supply chain think the pipeline is rapidly deteriorating, not because of a rise in completions, but because of cancellations.

A rapidly deteriorating pipeline? That’s the story

In the main, houses move along and through the pipeline, ending in the happy moment, where the new household get the keys to the dream.

But not all houses are completed, for a variety of reasons, only a few of which are in operation at any one time.

On the buyer side, incapacity to get or cover a loan, or some change in family circumstances can all arise. Most often, we are told, these lead to delays in building. We are yet to see significant data addressing delays associated with buyer inability to proceed, but there are enough stories around to know this is having some impact. The majority of stories focus on buyers withdrawing at the ‘early commitment’ stage, when they have paid an initial deposit, but have not ponied up the big deposit.

On the builder side, being stretched by cost increases (against a fixed price building contract), costly delays in getting materials and/or trades to site and getting work completed can result in builders defaulting or renegotiating contracts that become unaffordable for the buyers. These are all potential reasons a dwelling may not end up being completed.

Natural disasters also play their part.

Usually, these eventualities arise a couple at a time. It is uncommon for these circumstances to coincide, but indeed, they have done so, with something approaching vengeance.

As a result, the housing pipeline contains a fragility that has rarely been on display before, or at least, not at this magnitude.

It is a cruel irony that the same stimulus that pumped the house pipeline to bursting point fed into brutal inflation, which eroded spending power and the capacity to pay and then led to even further demand sapping in the form of twelve interest rate rises in thirteen months, aimed at bringing that same inflation under control.

As one industry leader noted, if you fix a price at the start of the job and the cost of materials and interest rates go up every month for a few months before the work even starts, you might well find both the buyer and the builder want to end the contract.

We can anticipate the pipeline is rapidly deteriorating, but how does that knowledge aid us in predicting the work going forward? The pipeline is just one indicator of the health of the supply chain. It is a good measure, but it is not complete, because it measures the work in hand, not the work coming along, nor, as we have discussed, the health of the pipeline.

What is the housing supply chain?

Ultimately, the housing supply chain ends with a dwelling – a place that one or more people can legally inhabit.

We work back from that end point, and for this analysis, the housing supply chain, is EVERYTHING that must be assembled, in an orderly manner, to achieve that excellent outcome of a household with somewhere to live.

'Everything' is all encompassing, so we need to break that down, into some logical steps, starting way back with land use decision making. So, from start to end, we might think of the housing supply chain as working in the manner set out below. We have included some notional timing to give a clue about what are 'leading' and what are 'lagging' indicators. The timeframes may vary, but we think the sequence is relatively close to accurate.

The key point about the housing supply chain is that once the building process has commenced – which necessarily includes the role of fabricators – the supply chain has very little new information on which to rely. In consequence, the story told by the pipeline data for new houses is fairly stable. It can – as is currently the case – be eroded by cancellations and delays, but it cannot increase without new approvals entering the market.

Readers of the quarterly Frame & Truss Sectror Overview and Outlook (FATSO) reports will see more of this discussion in the next edition.

Months to House Completion	Activity	Leading / Lagging?
>36 months	Land zoned for residential purposes	Leading
+/-36 months	Land released by Government, Council or Developer	Leading
15-36 months	Land is sold to BUYER – there are anecdotes about land release and registration delays impacting this phase of the building process	Leading
12-30 months	BUYER selects BUILDER **OR** BUYER purchases House and Land package	Leading
10-29 months	BUILDER applies to Council for Approval [minimum 1 month delay from sale, when approved, recorded in the national data]	Leading
	Finance is organised [minimum 1 month delay from sale, when finance approved, recorded in the national data]	Leading
Latest reports indicate up to 40% of sales are not proceeding past this point		

7-26 months	Commencement [historically, houses have taken less than three months to go from approval to building activity starting. That increased in 2021-22, but not dramatically]	Leading (Just)
~?	The magic of the building process happens, with all the trades and inputs required to achieve an outcome	Lagging or nil data
0 months	House handed over from BUILDER to BUYER	Lagging
-3 months	Completion recorded in the national data [as we have outlined earlier, completion times have blown out significantly over the last two years]	Lagging

It is a fair question as to what stage fabricators need to focus on when considering their future workload?

The data in the pipeline – commenced but not yet completed – provides useful guidance, but is incomplete, for all the reasons outlined.

We are still minded to a focus on dwelling approvals and lending finance data as a guide to the slightly longer term. The constraint being that the national data is somewhat limited when considered at the local level.

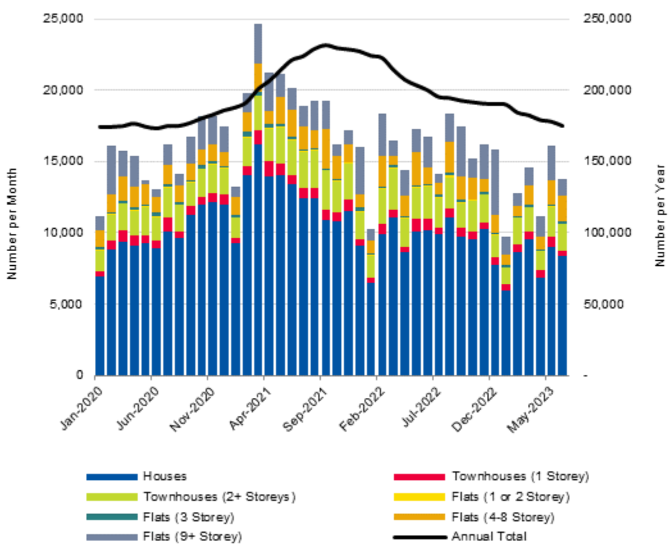
Beyond that, as can be observed in the following data, there are other trends that must not be ignored by business leaders.

Dwelling approvals still softening but not evaporating

Australian dwelling approvals are softening and will decline further. In 2021-22, approvals totalled 175,290 dwellings, down 12.4% on the previous year, as the chart below shows. It is notable that annualised approvals are only marginally down on (admittedly soft) pre-pandemic levels and it is also notable that although lower, monthly approvals have started flattening out.

What we like about the current approvals is most have been struck under the higher interest rates regime that looks set to pervade until perhaps mid-2025. These may be more sustainable than some of the rushed efforts of 2020 and 2021.

Australian Dwelling Approvals by Type: Jan ’20 – Jun ’23 (Number)



Source: ABS and IndustryEdge

Number	2021-22	2022-23	% Change
Houses	123,581	106,728	-13.6%
Townhouses (1 Storey)	7,774	6,476	-16.7%
Townhouses (2+ Storeys)	27,678	21,556	-22.1%
Flats (1 or 2 Storey)	718	571	-20.5%
Flats (3 Storey)	1,496	1,552	3.7%
Flats (4-8 Storey)	17,871	15,601	-12.7%
Flats (9+ Storey)	21,093	22,806	8.1%
Total	200,211	175,290	-12.4%

One notable shift in the market is that the larger declines have been taken up by the single family formats (houses and townhouses) more than in the apartments (4+ Storey dwellings). This is potentially cyclical, but equally is likely to be impacted by participation of developers bringing properties to market after the hiatus of the early pandemic period.

To examine this further, we took a peak at the housing finance data for the last year.

In 2021-22, total loans were valued at AUD298,368 million, or $298 billion, down 22.1% on the prior year. Feeding into that, all the headline loan types were down by similar margins:

- Owner-Occupiers -22.0%
- First Home Buyers -24.5% (note this is for owner occupation)
- Investors -21.0%

What this might suggest is that the national conversation about rent controls and the debate on the National Housing Future Fund that is currently before the Australian Parliament have not dampened investor interest in establishing new housing.

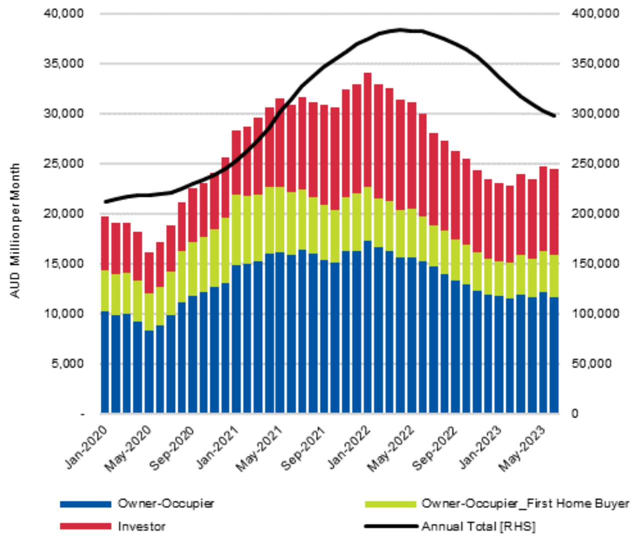
There are two other factors to note.

First, the monthly lending level has stabilised at around $25 billion, about 25% above pre-pandemic levels. That's reasonably healthy and is not all accounted for by inflation and housing price increases.

Second, the difference is being made up by renewed vigour in the investor lending area, which is understandable given the liquidity that still resides in the economy. If there is a worry in that trend it might be that some households facing the 'mortgage cliff' of coming off fixed and onto variable interest rates, could be looking to sell by the end of 2023.

Investors will potentially pick up the slack and even perhaps a bargain or two, pushing some people back into renting, in a market where there are insufficient rental properties already. Yet another reason why investors are likely to be in the market for some time to come.

Australian Residential Property Lending: Jan '20 – Jun '23 (AUD Million)



Source: ABS and IndustryEdge

The sum of the latest housing approvals and finance data is that far from crashing, while the Australian market is operating at below normal levels, it appears to have some emerging stability that might inform the future market as the remaining pipeline is built out or cancelled.

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