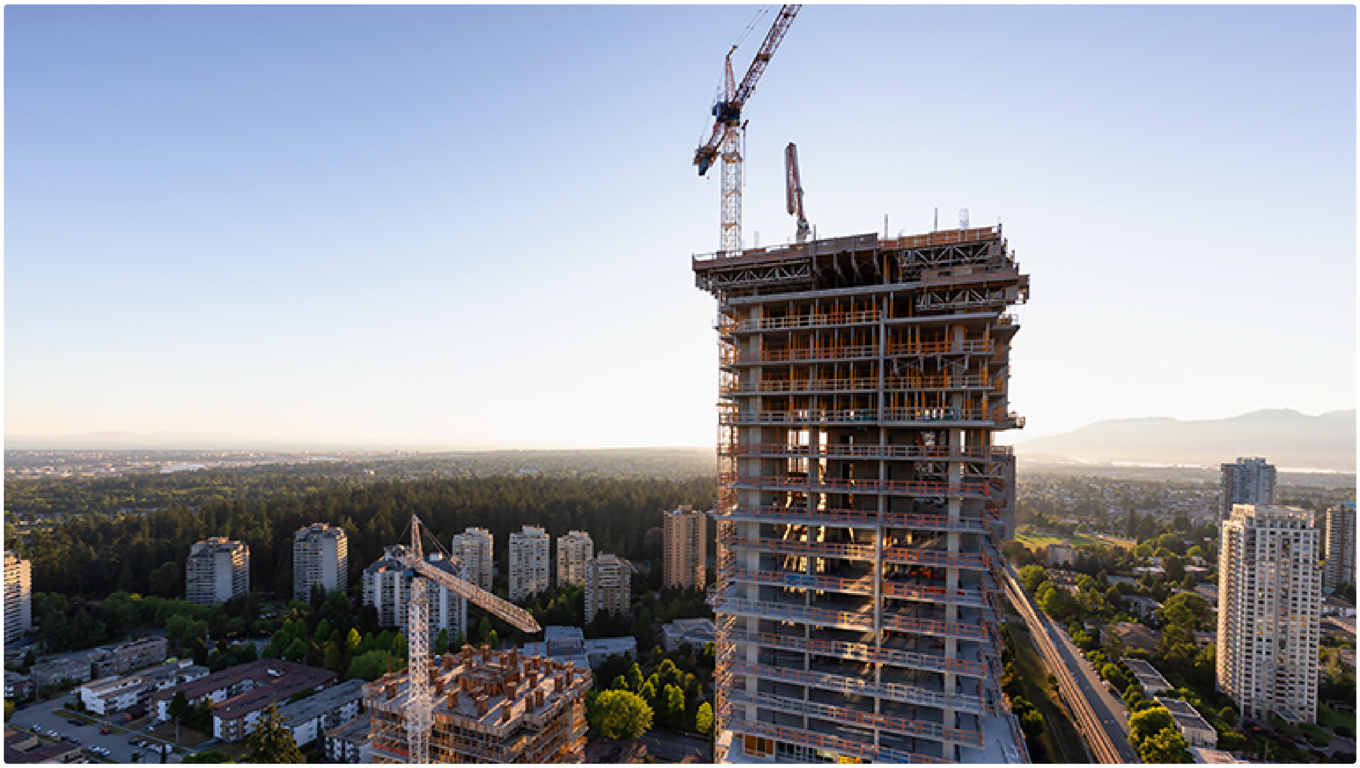
Marsh

Article

Inflation: The impact on the construction sector



How rising prices are affecting construction companies

Rates of inflation are increasing rapidly in many developed economies. And construction companies are feeling the effects — not only are essential materials and skilled labor significantly more expensive, but supply chain pressures and shortages are making it harder to secure needed construction materials.

Lumber, steel, and many other materials critical for construction projects have experienced skyrocketing increases in pricing. While the root of the problem was supply chain disruptions due to the COVID-19 pandemic, new challenges — including geopolitical risks — continue to put pressures on pricing. And an increase in government-led infrastructure activity is further increasing demand for construction materials.

At the same time, the available construction workforce is shrinking as an ageing cohort of skilled workers either retire or face local restrictions related to travel and workers move into other professions given competitive salaries elsewhere.

Skyrocketing costs impinge on slim margins

From a 66% increase in the price of fabricated steel, to major spikes in the price of softwood lumber, to a jump of more than 500% in the price of oriental strand board (OSB) — a wood product that is critical to the integrity of a building structure — the dramatic price hikes are having a significant effect on contractors and developers. Often, they have no option but to absorb the increased costs, eating into already slim margins and affecting their liquidity.

And lack of clarity about future costs is complicating the bidding process and affecting contractors' competitiveness. In the UK, for example, bid prices are expected to increase by up to 8.5% this year — up from 2021's 6% increase.

Rising fuel prices are putting even more pressure on contractors' budgets. Not only has it become significantly more expensive to get materials to a construction site, but many pieces of essential heavy equipment — such as bulldozers, cranes, and backhoes — run on fuel.

Labor shortages and increasing wage costs have been affecting the construction industry for a number of years. Given the broader economic pressures that exist, this challenge is unlikely to be resolved in the near future. Since wages can account for over 50% of the overall construction costs, the impact of labor pricing can have an acute influence on the profitability of a project.

What does this mean for the construction industry?

Since most contractors operate on slim margins, increased costs are impacting the bidding process. The steep recent price increases make it extremely difficult to estimate future costs, which may be several times the original estimates by the time work commences and more still by the time the job is completed. And delays in getting materials on site due to supply chain challenges often mean that the timeline for a project's completion is often unclear.

In most countries, the risk of inflation is borne by contractors. In these situations, incorrectly pricing costs into a bid can have catastrophic effects on their budgets, particularly for contractors that operate via fixed price contracts. This has led to an increasing number of construction companies getting into financial difficulties and even going out of business.

Some contractors and developers are facing increased challenges to secure funding for projects amidst questions about the bankability of projects. In a high inflationary environment, funders will generally be more cautious when offering funding to projects that are high in value, complex, or have long build times.

5 actions to address inflation

As inflation continues to affect economies and industries, contractors and developers should consider actions that can reduce the impact on their operations. Some actions include:

- **Review project budgets against current pricing.** Consider how inflation — whether for materials or labor — could impact the final cost of a project. Be realistic about the increased costs and make the necessary adjustments in your bidding process. Contractors may also consider adjusting their approach to bidding by adding contingencies into the pricing models to cater for future price uncertainties and increased costs.
- **Discuss risk sharing with stakeholders.** Have an open discussion with project owners about potential challenges and consider sharing the risk of inflation under contract conditions, whether through alliance-style agreements or alternate contract conditions for both new and existing contracts. This already takes place in some regions that have experienced long periods of high inflation, such as Latin America.
- **Consider supply chain challenges.** Construction materials are not only more expensive, but also becoming more difficult to secure. This new reality may require changing completion timelines both for ongoing projects and also in new bids.
- **Reassess your material procurement procedures.** Revisit your supply chain and assess its resilience when faced with both price increases and delays. Consider the

benefits of stockpiling essential materials and balance the benefits to budget and schedule against the additional costs of storage and security.

- **Revisit insurance policies.** Higher prices for material and labor will be reflected in the final cost of a project. And since losses will also lead to more expensive rebuilds, the sum insured may need to be revised to minimize the risk of being underinsured. Your construction insurance broker or advisor can assist you with the valuation process and help you assess your policy limits.