



EXECUTIVE INSIGHTS

Why the 2023 Australian Residential Building and Construction Outlook Isn't All Bad News

With interest rates increasing rapidly throughout 2022 and 2023, it's hard to open a newspaper without reading about the challenges facing the Australian construction sector. Recently, Porter Davis Homes was another established name in home construction to collapse, leaving around 1,700 homes in various stages of construction.

The traditional volume home builder model has been challenged over the past few years – volume builders sell houses on fixed price contracts and ordinarily deliver the homes within several months. Over the past few years, heightened demand for homes driven by government stimulus has coincided with supply chain disruptions, labour shortages and escalating inflation, which has resulted in builders taking longer to deliver completed homes and having to absorb significant price escalations while revenue (from fixed priced contracts signed 12+ months earlier) has remained static.

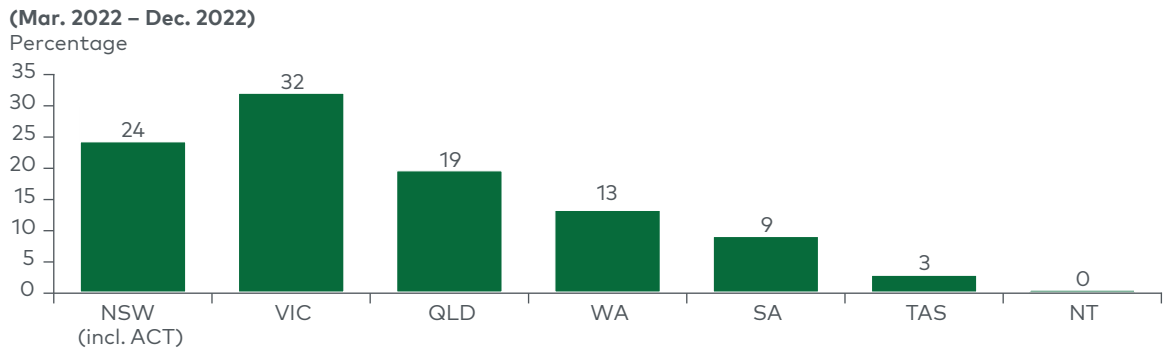
This got us thinking about whether it's all bad news, or if there are reasons to have some optimism in today's challenging market.

Victoria is a disproportionately large market for detached home construction, and downturns in home construction activity are therefore more impactful in Victoria

Victoria is home to around 25% of the Australian population, but its high rate of population growth and the expanding footprint of Melbourne and its surrounds support a much higher proportion of Australia's detached residential construction activity.

Victoria accounted for almost a third of all detached homes commenced from March 2022 to December 2022, consistent with building activity across states over the preceding five years (see Figure 1).

Figure 1
Proportion of detached construction activity by state



Proportion of Australian population	33%	25%	21%	11%	7%	2%	1%
Proportion of HomeBuilder	21%	29%	21%	16%	10%	3%	2%

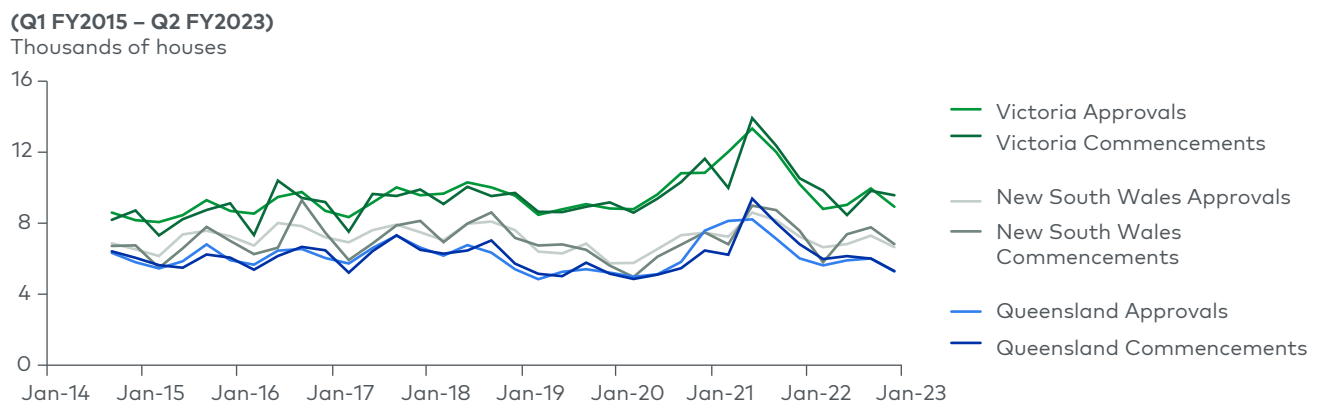
Note: NSW = New South Wales; ACT = Australian Capital Territory; VIC = Victoria; QLD = Queensland; WA = Western Australia; SA = South Australia; TAS = Tasmania; NT = Northern Territory
Source: Australian Bureau of Statistics

As a result, the Victorian sector has been more impacted by a downturn in construction of detached homes than have other states. HomeBuilder grants were also not evenly spread across Australia, with Western Australia attracting 16% of all grants despite only being home to 11% of Australia's population.

Headline falls in activity versus 2021-22 are significant – but detached approvals and commencements have returned to 2019 levels

With rising interest rates and construction costs, it's not uncommon to see headlines about construction activity falling by 50% versus 2021-22. This is true, but it is not the whole story (see Figure 2). In New South Wales, Victoria and Queensland, approvals and commencements for detached homes (as leading indicators of construction activity) are almost exactly back in line with 2019 levels.

Figure 2
Quarterly house* commencements and approvals by state



*Refers to residential detached dwellings only i.e., does not include medium- or high-density dwellings such as duplexes, townhouses or apartment blocks
Source: Australian Bureau of Statistics

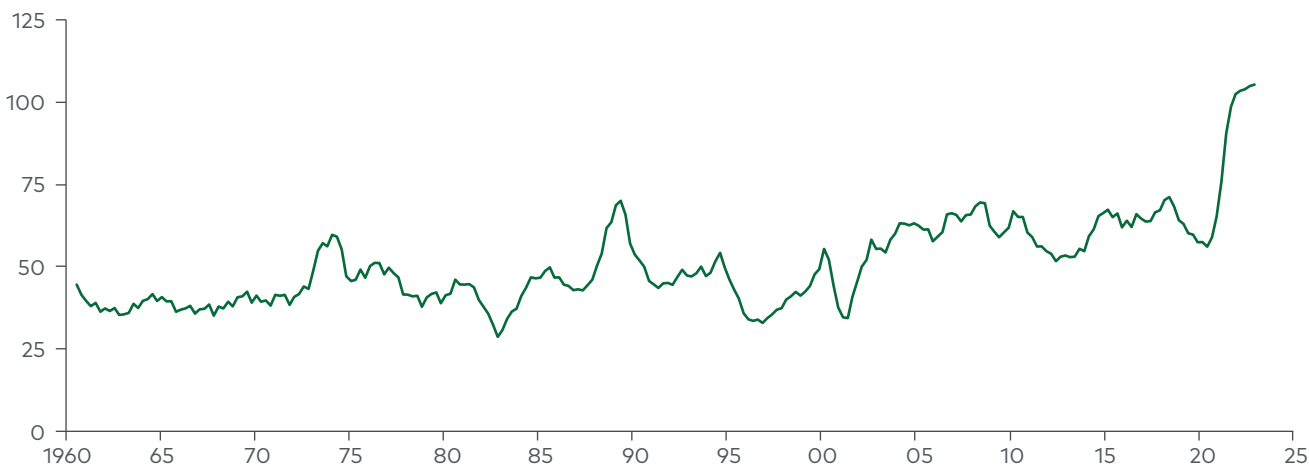
There is still a large backlog of new homes to be completed that will maintain activity well into the second half of 2023

With detached approvals and commencements numbers suggesting a return to 2019 activity levels, no doubt there's a tough adjustment coming after a bumper 2020-21.

However, there's still some time to go before the decreases in approvals and commencements translate into a significant decrease in building activity. The unprecedented number of approvals and commencements occurring during 2021-22 exceeded the industry's capacity to build, creating a significant backlog in homes to be completed (see Figure 3).

Figure 3
Dwellings under construction (new houses, all sectors)

(Sept. 1960 – Dec. 2022)
Thousands of dwellings

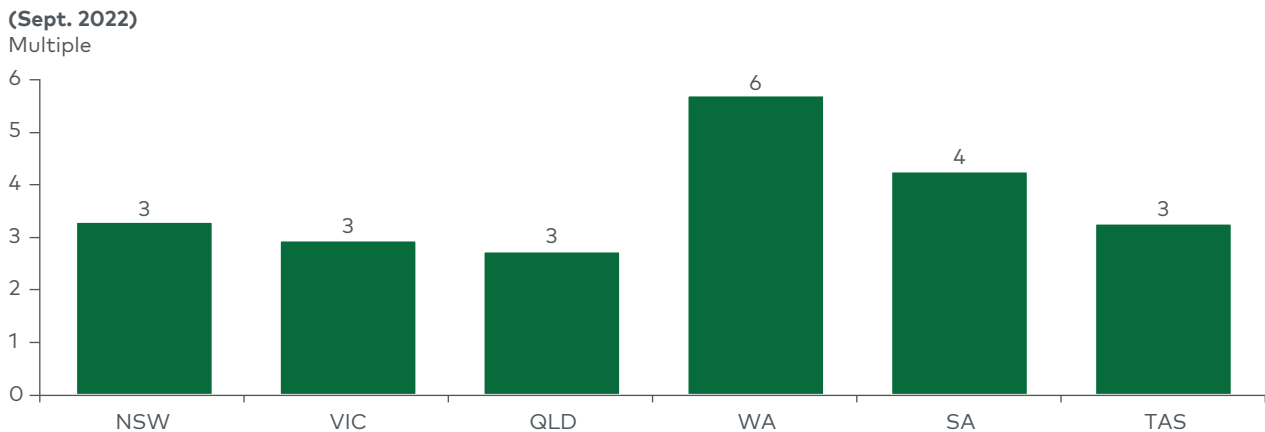


Source: Australian Bureau of Statistics

With approximately 100,000 homes under construction as of September 2022 (see Figure 4) and commencements still running at around 30,000 new homes for the quarter ending December 2022, there's still some way to go for the industry to complete the existing backlog. In fact, this backlog is likely to persist well into the second half of 2023, if not beyond, as the fastest completion rate of detached dwellings demonstrated by the Australian construction industry was only 35,000 in December 1994 quarter.

Proportionately, the backlog is particularly large in Western Australia.

Figure 4
Detached dwellings under construction as a multiple of 5-year average quarterly commencements, by state



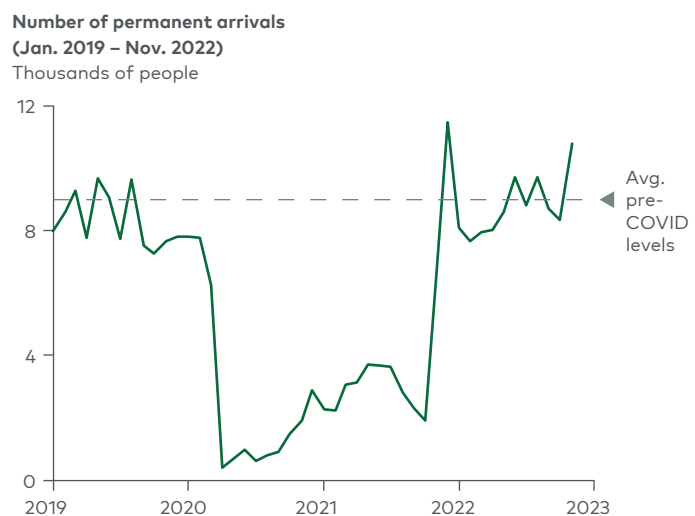
Note: NSW = New South Wales; ACT = Australian Capital Territory; VIC = Victoria; QLD = Queensland; WA = Western Australia; SA = South Australia; TAS = Tasmania; NT = Northern Territory
Source: Australian Bureau of Statistics

The long-run fundamentals for Australian construction remain strong – population growth driven by migration has already returned, and rental vacancies are at record lows

Australia has one of the highest rates of new home construction per capita in the world, reflecting its high rate of population growth compared to its developed peers (see Figure 5). Not only is the rate of home construction high, but an Australian home is typically larger and more likely to be detached than are houses in other markets – in fact, Australia builds more detached houses per year than does Germany, a country with three times the population of Australia.

Figure 5
Australian housing statistics and population growth

Country	Residential commencements per 1,000 population (2021)*	Housing stock per 1,000 population**	Annual population growth (2012-22)
Australia	8.3	398	1.4%
France	5.9	591	0.3%
United States	5.3	420	0.6%
Netherlands	4.1	455	0.5%
Belgium	3.6	486	0.5%
Germany	3.5	507	0.4%
UK	2.9	438	0.6%
Spain	2.0	551	0.2%
Italy	1.0	590	(0.1%)
Russia	0.6	(n/a)	0.0%
New Zealand	6.9	395	1.7%



*Residential completions figures used for some EU countries (Germany, France, Italy) and New Zealand where housing start data is unavailable; **Latest available data ranges from 2018-2020
Source: Australian Bureau of Statistics, World Bank; OECD – Housing Stock & Construction; European Commission Eurostat; US Census Bureau; Statistisches Bundesamt; Istat; CBS; FIEC; UK Gov

This population growth has largely been driven by migration to Australia from other countries. With the closure of Australia's borders for much of the COVID-19 pandemic through 2020-21, Australian population growth stalled. However, migration has already returned and is at or above pre-COVID-19 levels.

With such strong population growth, Australian construction can remain at subdued levels for only so long. Amongst the developed nations set out in Figure 5 above, only New Zealand has fewer homes per capita than Australia. This dynamic is currently playing out in Australia with rental vacancies at historic lows.

Hopefully Australia will avoid a repeat of the 30% decrease in detached commencements seen during the 1990-91 recession

Before COVID-19, Australia had not had a technical recession since 1990-91, avoiding recession in both the dot-com crash in 2000 and the global financial crisis in 2008-9.

In the absence of more recent economic downturns in Australia, L.E.K. Consulting has found that many of our clients are interested in understanding what the 1990-91 experience would look like if repeated in the current context.

Numbers of detached housing commencements in FY1989 were similar to the commencements in FY2022, with both around 130,000 p.a. (FY2021 was a higher peak: 140,000 commencements). The 1990-91 recession resulted in detached housing commencements falling from a peak of c.130,000 p.a. in FY1989 to c.90,000 p.a. in FY1991.

A similar fall if replicated today would result in c.96,000 houses commenced in FY2023 and recovery starting during FY2024.

Fortunately, the decline in commencements to date is less significant than was observed in the early '90s, and we benefit from unemployment at c.3.5% running near historical lows.

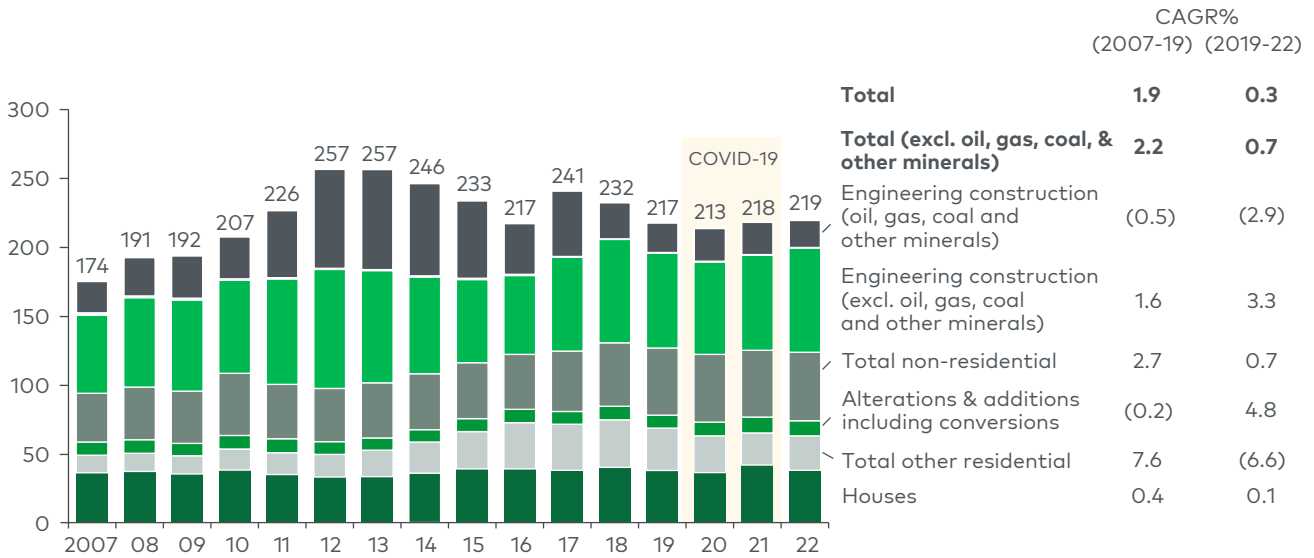
With strong investment into infrastructure and multi-residential becoming increasingly important, there is a good deal of construction activity occurring beyond detached housing

Detached housing is an important part of the Australian construction market, but there's plenty of other activity going on (see Figure 6). Residential construction — both detached and other residential/multi-residential (apartments) — typically accounts for about 30% of the value of construction done in Australia, but the infrastructure boom can clearly be seen in the high levels of other construction activity occurring in recent years.

Figure 6
Value of construction work done in Australia

(2007-2022)

Billions of AUD (chain volume measures)



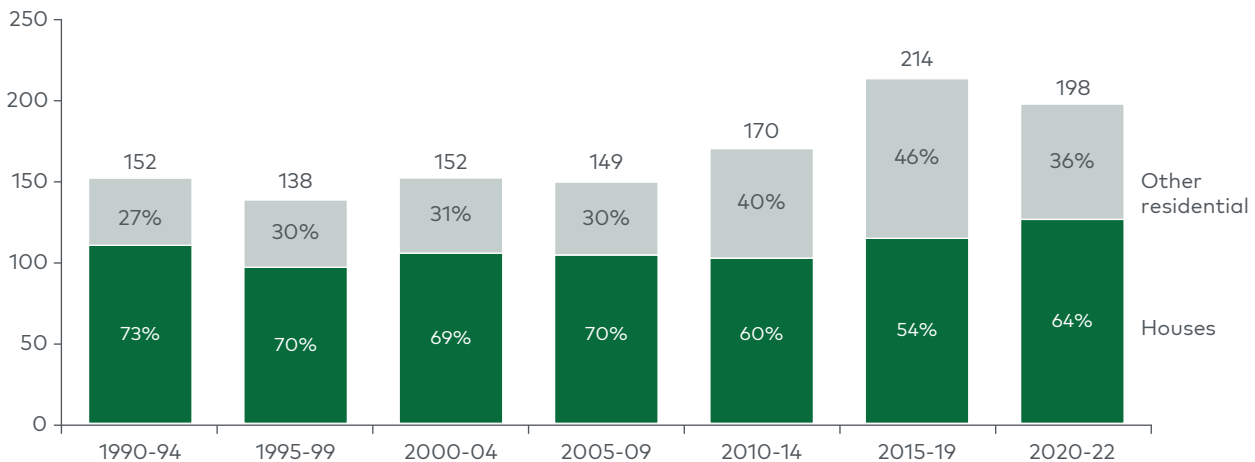
Note: AUS = Australian Dollar
Source: Australian Bureau of Statistics

There's also reason to think that strong activity will be coming in multi-residential construction. While multi-residential construction was muted during COVID-19, there has been a long-term trend towards increasing apartment construction (see Figure 7) – but whether the return of strong migration will drive construction of apartments in the face of rising interest rates remains to be seen.

Figure 7
Commencements by dwelling type (5-year average)

(1990-2022)

Millions of commencements



Source: Australian Bureau of Statistics

Conclusions

Early indicators and daily news headlines are clearly showing that the outlook for detached housing construction is deteriorating, and commencements are expected to drop from the peak observed in 2021. The situation is particularly severe in Victoria due to its relative over-exposure to detached housing. However, despite the poor outlook, several factors will limit the depth of the downturn.

First, more houses are needed in Australia given the current level of rental vacancies and the rate of net overseas migration. This is particularly true in Australia given that housing stock per capita is already at internationally low levels, leaving limited room to increase the efficiency of our housing stock.

Second, detached housing is only one segment in the Australia construction market. Australia is going through a structural shift towards multi-residential construction and has a strong pipeline of work in non-residential building and construction which will buffer the pain for suppliers and tradespeople.

To learn more about market factors and key themes in building materials & construction in 2023 and beyond, please contact Alastair Phillips, Antonia Morris, George Woods or Steph Newey at strategy@lek.com.

About the Authors



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Alastair Phillips is a Partner in L.E.K. Consulting's Industrials practice, based in the Melbourne office. He joined the firm in 2014 and has worked with clients across Australia, New Zealand, and Southeast Asia. Alastair has extensive experience across the industrials sector in growth strategy, emissions reduction, customer segmentation, post-merger integration, M&A, distribution strategy, and pricing strategy.

Alastair holds an MBA from Melbourne Business School and both a Bachelor of Actuarial Studies and a Bachelor of Laws from Australian National University.



Antonia Morris
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Antonia is a Manager at L.E.K. Consulting's Melbourne office, with over 7 years of consulting experience across Australia and Europe.

Antonia provides advice to a set of broad clients across building materials and the broader industrials space. Antonia has experience assisting clients with a range of strategic and commercial issues, including strategy development, market analysis, competitive positioning, financial modelling, cost reductions, and M&A advisory.

Antonia holds a Master of Engineering and Bachelor of Commerce from The University of Melbourne.



George Woods
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George Woods is a Partner in L.E.K. Consulting's Sydney office. George is the Regional Head of L.E.K.'s Industrials practice and leads L.E.K.'s Asia-Pacific Airports practice. George offers clients over 23 years' experience to major corporates, private equity firms, and the public sector to assist clients with corporate strategy development.

George specializes in developing regional strategy, competitive strategy, M&A strategy, and new plant investment. Much of his work concerns responses to globalizing supply chains, vertical integration, and customer value proposition. He has acted as an honest broker in industry-redefining mergers in cement and bricks.

George holds an MA in mathematics from Queens' College, Cambridge, where he was a Foundation Scholar. He also holds an MBA with distinction from INSEAD, France.



Stephanie Newey
Partner, Sydney

Stephanie Newey is the Managing Partner, Head of L.E.K. Consulting Australia, and co-leader of the Australian Healthcare practice. She has more than 20 years of experience in strategy and consulting, with deep expertise in the building materials, construction, and waste management industries, biopharmaceuticals, life sciences, and healthcare services.

Stephanie has advised a broad range of building material clients on major strategic issues and assisted clients in delivering major corporate transformations. Her experience spans the full spectrum of building products, from heavy to light construction products, and all segments of the value chain, from material supply/sourcing, to manufacturing, to distribution, to contracting and installation.

Stephanie graduated from the University of Technology Sydney with a degree in accounting and finance and was awarded a University Medal.

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