BULLETIN

25 July 2023

Non-residential building activity, in focus.
A bright spot in the gloom.
Upward trend in non-res' building activity to extend into 2024.

The economic outlook for Australia over the year ahead is decidedly downbeat as the intense headwinds of rapidly rising interest rates and high inflation impact. Westpac Economics anticipates that the economy will slow to stalling speed, with output growth in the year to mid-2024 forecast to be in the order of ½%. Since 1980, on only three occasions has annual output growth moved below 1%: the early 1980s recession; the early 1990s recession; and the covid recession of 2020.

Within this gloom, non-residential building activity will be a bright spot for the year ahead. Here, in our focus on non-residential building activity, we put the spotlight on forward indicators for the sector and assess the implications for the year ahead outlook. For context, private non-residential building activity is 20% of business investment and 80% of the size of private new dwelling activity.

Non-residential building approvals: march higher, recovering from covid related setbacks

The non-residential building sector is experiencing a period of material positive momentum – recovering from the disruptions caused by the global pandemic.

At the outset, we note that – structurally – there is an underlying upward trend in real non-residential building activity. The nation needs to expand the capital stock to meet the requirements of Australia's rapidly rising population – capital widening. Australia's population expanded by a quarter in the space of only 13½ years prior to the pandemic (with Victoria's population up 30% over that period). Rising incomes and living standards further add to demand.

Other dynamics also contribute to the underlying upward trend, such as: the need to replace demolitions (e.g. metro lines being built in Sydney and Melbourne, resulting in knock downs); the need to refresh aging capital stock for new innovations; to meet shifting demands, in part associated with changing demographics; and associated with ongoing competition.

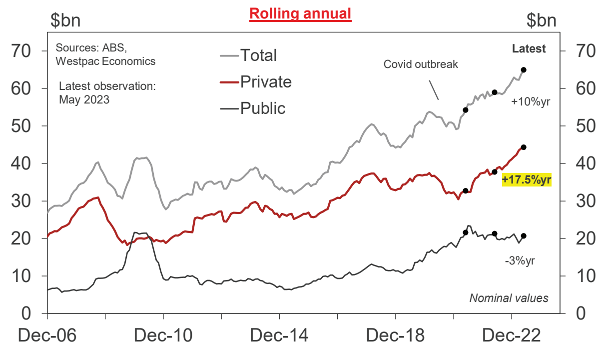
In 2020, the pandemic triggered a sizeable setback for the non-residential building sector - with approvals slumping throughout much of that year. At the low point, private building approvals in the year to February 2021 were 19% below that over the year prior. Strength in the public sector provided a partial offset, limiting the decline in total approvals to 8%.

In the second half of 2021, the delta outbreak and lockdowns in NSW and Victoria represented another setback for the sector – with private approvals tending to stagnate for a period.

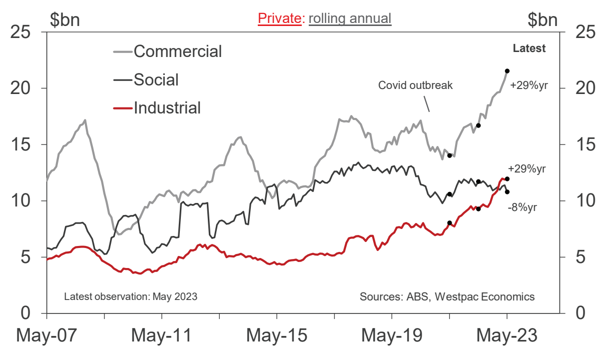
With those covid disruptions behind us, the sector has made gains, resulting in the emergence of significant positive momentum. Private non-residential building approvals for the year to May 2023 are 17.5% above that for the year prior and some 35.5% higher than for the year to May 2021.

Rising costs are a factor – accounting for part of the increase in the total value of building approvals. Adjusting for inflation, on our calculations, still leaves a clear material upward trend – with real private building approvals for the year to May 2023 some 9.6% above the year prior, to be 17.7% higher than two years earlier.

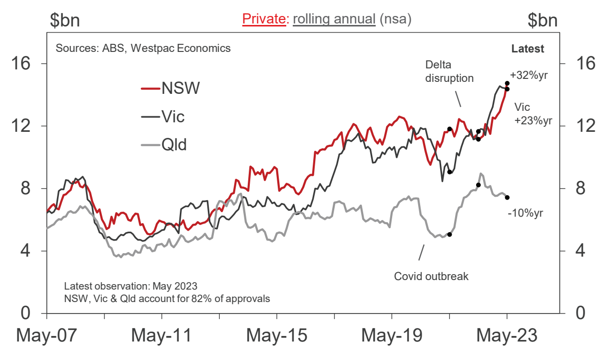
Non-residential building approvals: march higher



Non-residential building approvals: segments



Non-residential building approvals: states



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For public works, trends and timing differ. Currently, annual approvals are, in nominal terms, 3% below that a year earlier, such that the value of total building approvals for the year to May 2023 are 10% higher than a year earlier.

As to commencements, they have closely tracked approvals over the past year – there is no evidence of project cancellations as an issue.

Industrials and commercial segments lead the way higher

The 17.5% annual increase in the value of private building approvals is centred on two of the three broad segments which make up the sector, namely industrials and commercial.

Industrials are experiencing a strong burst as businesses respond to shifts in demand patterns post the pandemic. Additional warehouse space is needed post covid, as folk shop online more and expect quicker delivery times – "click and deliver" / "click and collect" is the new shopping mantra. Against that backdrop, private industrial building approvals in the year to May 2023 are 29% above that a year earlier and a staggering 48% higher than two years ago.

Commercial building approvals have climbed, as a wave of projects proceed, in part a catch-up following covid disruptions. Approvals in the year to May are also 29% above a year ago and 53% up on two years ago. In dollar terms, half of the gain for the past year is due to offices (consistent with their share) - with broad based rises across transport buildings, other commercial and to a lesser extent, retail.

For offices, as noted above, current strength – with synchronised upswings in NSW and Victoria – represents a rebound from the extreme lows during covid (Victoria –56%yr in May 2021 and in NSW a double dip, –47%yr in September 2020 and –41%yr in March 2022). This clustering of projects has approvals spiking to levels which are unlikely to be sustained given high office vacancy rates.

The varied social building segment is transitioning a period of mixed fortunes. Approvals are 8% below that a year ago and only 2% higher than two years earlier. This represents a period of under investment in social building – setting the scene for a likely catch-up over the years ahead. Accommodation – impacted by the closure of the national border – is a source of weakness. Approvals there are 35% down on a year ago and almost 60% below that in 2019, pre-covid, which represented a period of strength. A similar picture is evident in aged care – an area where demand is trending higher – with approvals 18% below a year ago and 46% below that in 2019.

Delta states lead the upward trend

Of Australia's 26.27 million population, 77.4% or 20.32 million live in the three eastern mainland states, NSW, Victoria and Qld. Accordingly, these three states account for the bulk of non-residential projects – some 82% of private approvals.

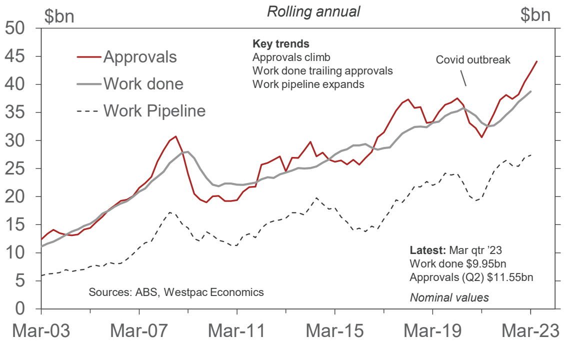
It is the delta impacted states of NSW and Victoria, which are driving the current upward trend in approvals. For Qld, approvals are lower over the past year, down 10%.

The construction of rail networks in Sydney and Melbourne is adding to the upswing – indirectly (through the impacts of office demolitions) and directly (with a spike in transport building approvals, as new train stations are built).

For NSW, private building approvals in the year to May are about 1/3rd higher than a year earlier. Commercial is the biggest driver of that increase, of which half is accounted for by offices – which have returned to around the levels prevailing pre-covid, in 2019.

In Victoria, private building approvals in the year to May are 23% above a year ago. Industrials, which represented only 20% of total approvals in 2019, pre-covid, jumped 60% in the past year, to account for 55% of the total gain over that period. Commercial building approvals are 29% higher over the year, with gains centred on other commercial and offices.

Non-residential private building: overview



Work done trails approvals, pointing to upward trend in activity

Broadening the focus from approvals, the key trends in the private non-building sector are that: work done is trailing the upswing in new projects; and that the pipeline of work outstanding is expanding. This combination points to a clear and material upward trend in building activity over the quarters ahead, likely extending into 2024.

By way of context, as at the March quarter 2023, real non-residential building activity was 4.7% higher than at the start of 2022, but still some 3.5% below that at the end of 2019, pre-pandemic.

The value of building work completed in the past three quarters to March, printed $9.83bn, $9.75bn and $9.95bn. The most recent outcome is 11% below the average value of approvals for the past year. Adjusting approvals for inflation yields the same result – the real value of work done in the March quarter 2023, now at $8.68bn, is 11% below the average real value of approvals over the past year.

The pipeline of work outstanding is elevated, to be 15% above pre-pandemic levels, including a rise of 3.5% over the past year – and with a likely further increase in mid-2023. That said, part of the upward trend in the value of the work pipeline does reflect rising building costs.

Risks to the outlook

Beyond the positive year ahead outlook for private non-residential building activity, the sector faces some risks – both downside and upside.

To the downside, weak consumer spending – as households feel the pressure of higher interest rates and high inflation – will dampen the appetite for new non-residential building projects to commence in the near-term. For the office sector (which accounts for around 23% of total private approvals), the shift to work from home post covid is weighing on the demand for space in the CBDs of capital cities, resulting in elevated vacancy rates – albeit, in 2023 the city centres are buzzing again mid-week. That said, with companies recognising the need to reinvigorate work environments to encourage even more people back to the office, firms will be looking to invest in A-grade stock.

To the upside, Australia is again experiencing rapid population gains, with annual growth approaching 2% at the end of 2022, and likely to accelerate in 2023. That points to the need for a further capital widening. For the social building segment, the current subdued level of approvals suggests a period of under investment – pointing to the need for catch-up in the years ahead.

Andrew Hanlan, Senior Economist

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