Box C

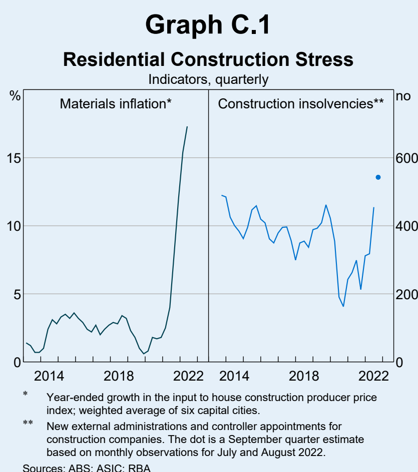
Financial Stress and Contagion Risks in the Residential Construction Industry

The residential construction industry in Australia is facing challenges due to the sharp rise in construction input costs, compounded by shortages of labour and materials, which has eroded profit margins on existing fixed-price contracts (Graph C.1). Reflecting these pressures, a number of large residential construction firms have entered into insolvency over the past year. Overall, construction company insolvencies have increased sharply, exceeding their pre-pandemic levels and accounting for close to 30 per cent of all company insolvencies. More recently, the increase in interest rates has begun to raise debt-servicing costs for many firms, adding to financial pressures. Further increases in insolvencies are likely. While the direct implications for the financial system are limited because banks have very small exposures to builders, there is potential for financial stress to spread to other businesses within the broader construction industry and to some households.

Profitability has declined for most builders and margins are likely to remain under pressure in the near term

Builders typically offer contracts to build homes at a fixed price with considerable lead time, which has left many builders exposed to the sharp increase in the costs of materials and labour since the start of 2021; the cost of building materials alone has increased by more than 20 per cent over this period. As such, profit margins for existing fixed-price contracts have compressed substantially, and builders are now making losses on some contracts. Ongoing delays as a result of supply-chain disruptions, inclement weather and illness-related workers' absences have resulted in further increases in costs and have delayed when payment milestones are reached. According to industry contacts in the Bank's liaison program, construction delays for detached homes are currently around 12 weeks on average – and much longer than this in some instances. Builders have responded to these challenges by raising the prices on new contracts, shortening the period before a quote must be accepted and renegotiating some of their existing contracts.

Nonetheless, the share of medium-sized and large builders (who build the majority of new housing) recording negative net operating cash flows in a given quarter has risen sharply since the start of 2021 (Graph C.2). The likelihood of having persistently weak cash



flows over the year has also increased, including for large builders whose size may have given them some advantages in managing the ongoing disruptions. Over 25 per cent of the largest 200 builders recorded an operating loss in the year to March 2022, up from a little over 15 per cent a year prior.

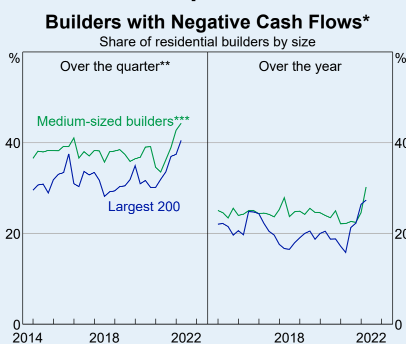
Recurring operating losses due to rising costs and delays have led some builders to run down their cash reserves, which were built up through the COVID-19 pandemic aided by the receipt of government support payments. Survey data from January 2022 suggest many firms in the broader construction industry were drawing down their cash reserves at a faster rate than firms in other industries. Running down reserves can quickly become problematic for builders because they tend to have lower liquidity buffers – that is, cash and other short-term assets (such as inventories and accounts receivable) – than other businesses. As of the latest available detailed data from June 2020, builders' liquidity buffers were typically equivalent to less than three months of turnover, which was around 25 per cent lower than for other businesses of similar size (Graph C.3).

In response to the financial stress caused by ongoing pressure on margins, information from liaison with banks suggests builders that predominantly work with other developers instead of retail buyers have been able to switch to more flexible contracts that allow them to pass higher materials or labour costs onto their customers even after the contract is signed. Banks have also responded by working more closely with financially stressed builders to resolve liquidity issues as they arise. However, further insolvencies are expected in the near term as many builders continue to work through fixed-price contracts taken on when costs were substantially lower and as higher interest rates increase debt-servicing costs. Moreover, new and existing fixed-price contracts remain exposed to further increases in input costs.

Graph C.2

Builders with Negative Cash Flows*

Share of residential builders by size



* Net operating cash flows calculated as operating revenue less operating expenses and wages; not including government support payments (e.g. JobKeeper); incorporated builders defined as per ANZSIC 301.

** Seasonally adjusted share.

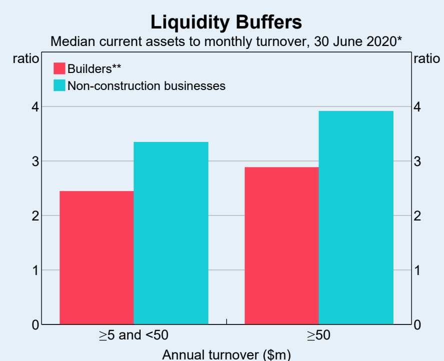
*** Builders outside of the largest 200 with annual turnover of at least $5 million (~1,400 firms).

Sources: ABS; RBA

Graph C.3

Liquidity Buffers

Median current assets to monthly turnover, 30 June 2020*



* Current assets include cash and other short-term assets; average monthly turnover for 2019/20; includes companies only.

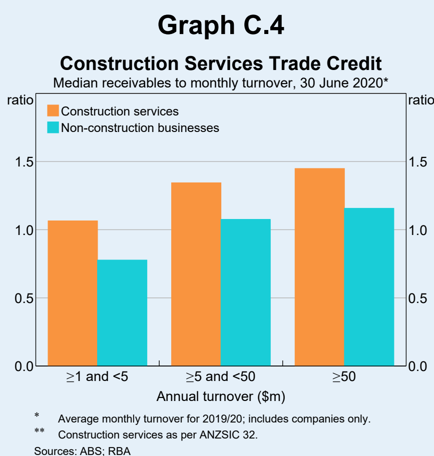
** Builders defined as per ANZSIC 301.

Sources: ABS; RBA

Subcontractors have absorbed builders' financial stress to date, but risks are elevated

Builders rely heavily on engaging subcontractors (e.g. for concreting, bricklaying, roofing, installation services etc), which means these businesses are highly connected. Financial stress can quickly spread from troubled builders to these construction services businesses through delays or defaults on payments for work already done. For the median builder, around 40 per cent of total liabilities were short-term unsecured trade credit (i.e. unpaid invoices) in June 2020 – around twice as much as for other businesses. Failures of larger builders tend to affect a high number of construction services businesses, which in turn have the potential to transmit stress more widely through their own subcontractors. Financial contagion risks in the construction services industry are exacerbated by these businesses having higher unpaid receivables than other businesses, typically around 1.5 times their monthly turnover for the largest firms (Graph C.4).

To date, transmission of financial stress from builders to their subcontractors appears to have been limited. Liaison with banks suggests that the majority of subcontractors affected by recent builder insolvencies have been able to absorb disruptions to their cash flows using their cash reserves or existing lines of credit, and some have been able to access additional credit. Some subcontractors have also responded to higher risks by shortening payment times for builders, thereby reducing their stock of trade credit exposures at any given time.

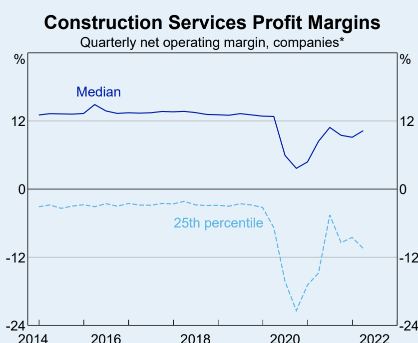


Nonetheless, risks of more widespread financial stress in the construction sector remain elevated. Although construction services businesses are typically able to raise their prices more easily than builders, ongoing input cost inflation, material delays and labour shortages are also weighing on their profitability and liquidity buffers. By the start of 2022, the share of construction services businesses running operating losses had declined substantially from elevated levels that followed lockdown-related disruptions; however, net profit margins have generally remained lower than pre-pandemic levels (Graph C.5). Reflecting the ongoing challenges, the net operating profit margin at the 25th percentile has declined since the middle of 2021. Going forward, higher interest rates will contribute to increased debt servicing costs for indebted construction services businesses, and will increase the risk of insolvency for some. The most vulnerable subcontractors are those that are unable to diversify their revenues and primarily work with one builder at a time; should that builder default on outstanding invoices, the subcontractor could quickly struggle to meet its own payment obligations.

Banks' direct exposures to construction firms are low, but there are indirect links through households

Banks' exposures to builders and the construction services industry are small, which limits direct risks to the financial system. Combined lending to the two industries was less than $40 billion as of August 2022 – or about 0.8 per cent of total bank assets – and accounted for only a small share of assets at each domestic bank individually. Some non-bank lenders may have more substantial exposures relative to their total assets, but their market shares are small. As of March 2022, major banks' arrears rates on construction business loans remained very low by historical standards. While banks expect arrears rates to rise following the increase in interest rates, ongoing prudent lending standards for construction businesses should help to contain the magnitude of any deterioration in credit quality.

On top of these direct exposures, banks also have indirect links to construction businesses – in particular, through households that own and operate small construction businesses and depend on business income to service their own debts. Based on household surveys, around 2 per cent of residential mortgage borrowers are estimated to rely on business income from the construction industry. In addition, many household borrowers depend on the construction industry to some degree, as construction accounts for close to 10 per cent of total employment. Furthermore, those households currently building a new home are exposed to the industry and are likely to have mortgages with banks.



Risks of transmission to household financial stress depend on the outlook for construction activity

Financial stress remains low for the majority of households that own and operate small construction businesses as demand for their services (generally trade labour) remains strong. As such, even though net profit margins for construction services businesses are lower than before the pandemic, the additional turnover has partly offset this for many businesses. Personal insolvencies related to business failures – for example, insolvencies of company proprietors or sole traders – remain around record lows in the construction industry (Graph C.6). Continued strong demand for construction workers is also supporting employment incomes in the industry, and has allowed the small number of workers from failed construction firms to quickly find work elsewhere.

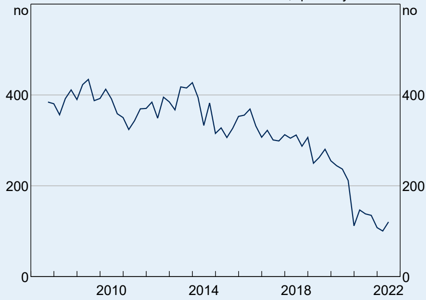
The large pipeline of work in the residential construction sector should continue to support activity and employment for the next year or so. However, once this pipeline has been worked through, activity is expected to be weaker, given the impact of falling housing prices and high construction costs. Risks of broader transmission of

financial stress across the industry and to households would increase if residential construction activity slows substantially and input costs remain high.

Graph C.6

Personal Insolvencies

Related to construction businesses, quarterly*



* New personal insolvencies of business owners/operators (e.g. sole traders or directors of proprietary companies).

Sources: AFSA; RBA