# THE CONSTRUCTION SPENDING PARADOX:
## Is It Growth or Inflation?


March 2022

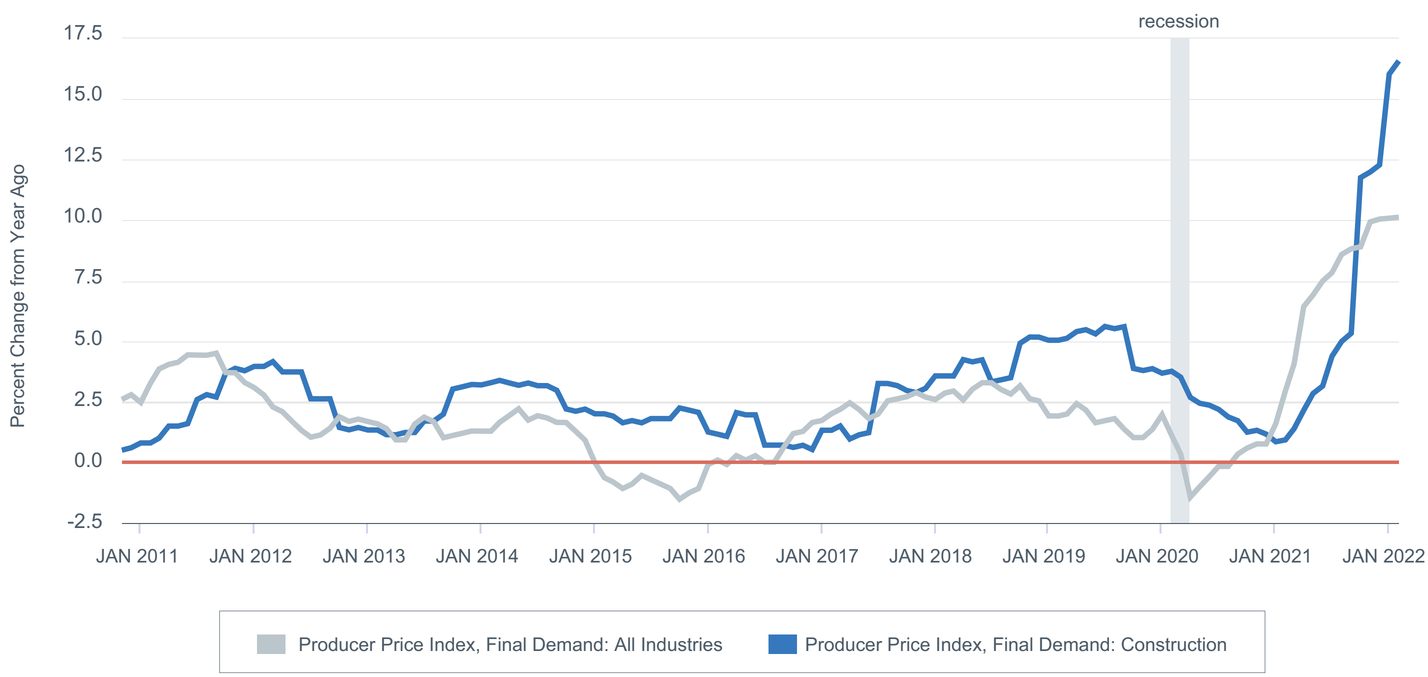
Construction Industry
Round Table

# How can contractors remain competitive as production costs rise?

Liam Dalton, professional engineer, is an expert in finding ways to make things work. As vice president at HNTB, an infrastructure design firm, he often develops alternate technical concepts for contractors, substitutes materials and finds ways to expedite projects. Even so, he says 2021 was a tough year for contractors with ongoing supply chain issues, extreme weather events and materials price hikes.

"Getting delivery of long-lead items is problematic," he says. "[Contractors] can't get the materials, and they can't get them for the price [they quoted]; so, with all those factors, the bid price would traditionally have skyrocketed."

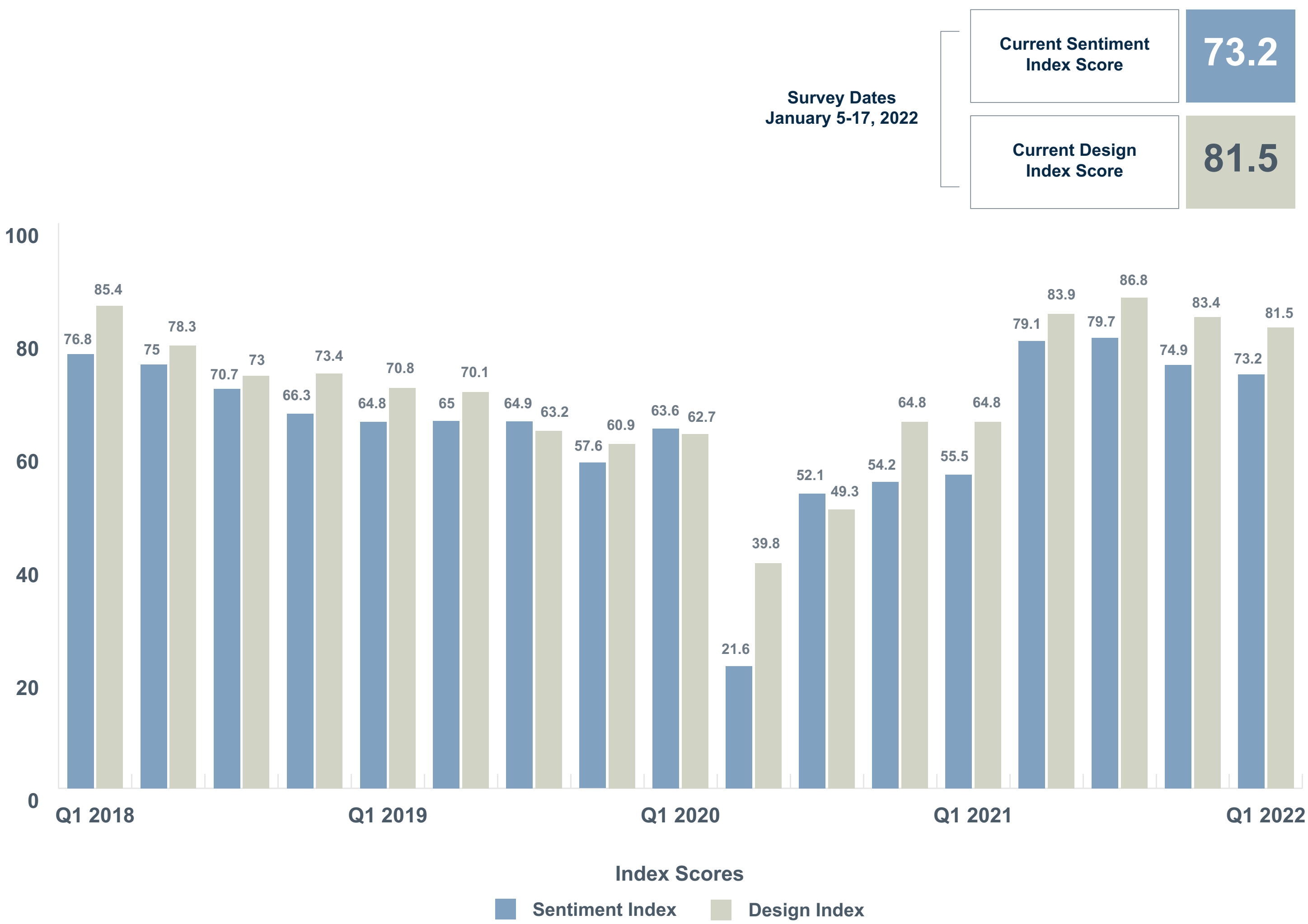
Bid prices, however, haven't skyrocketed. In February 2022 consumer prices climbed 7.9% year over year—well above the Federal Reserve's target of 2% and the highest in four decades, driven by rising costs for food, energy and apparel. At the same time, the 12-month producer price index remained steady at 10%. This has left contractors juggling steeply rising input costs, stalling advances in bid prices, and taking larger shares of project risk.




Source: U.S. Bureau of Labor Statistics

We see a degree of anxiety reflected in the Construction Industry Roundtable (CIRT) Sentiment Index, which softened to 73.2 from 74.9 in the first quarter of 2022, just below the historic high recorded in the third quarter of 2021. This is due to pressure from supply chain challenges and labor shortages as well as increasing concern over the broader U.S. economy. Four out of 5 respondents said backlogs exceeded 80% of capacity, while approximately the same share of CIRT respondents had project delays in 2021 from supply chain issues.

## CIRT Sentiment Index And Design Index Scores From Q1 2018 to Q1 2022



> "The predictability of when you might receive materials or equipment is so much different than it has been in the past. It takes a lot of extra effort to manage that. And it's harder to deploy lean principles of just-in-time deliveries."
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> Mike Choutka, president and chief executive officer of Hensel Phelps

One of the few guarantees at this moment appears to be continued volatility. The Fed raised interest rates 25 basis points in March in an effort to combat inflation. This policy shift has already begun to increase borrowing costs, but will ultimately decrease demand for expansionary investment.

Inflationary pressures are not confined within the U.S. We are now facing new geopolitical challenges with Russia's invasion of Ukraine and the subsequent international reaction and sanctions imposed on an already fragile international supply chain.

These new challenges have already increased barriers on international oil supplies and select crops (e.g., wheat) resulting in climbing energy and food prices. It is still early to understand the long-term effects on other areas of manufacturing capacity (e.g., chemicals) and the financial markets, but they are expected to be significant.

Additionally, the spending from the Infrastructure Investment and Jobs Act (IIJA) will begin to come online later in the year, upholding focused investment into important domestic infrastructure and potentially rebalancing an already thin construction labor force.

FMI forecasts 5% growth in construction spending across residential, nonresidential and nonbuilding construction in 2022, but the economic outlook is complicated. Firms with a deep understanding of their region and niche will be better positioned to capitalize on the slate of upcoming projects, while those that go after projects without a solid go-to-market strategy will risk taking a hit to their margins or face failure in delivery. At this time, it is critical for firms to minimize risk by acting strategically in choosing which projects to bid. Our research shows that strict project selectivity increases a company's odds of success in a competitive and volatile environment.

Here, we explore the effect of some key economic dynamics and look at how those will impact competitiveness in a booming market.

## Spending more for less

When material and labor prices go up, projects of course become more expensive to execute.

The price index for steel mill products jumped 112.7% in January from the prior year, while lumber prices stood at three times their pre-pandemic high in February 2022. These are just two examples of the dicey nature of procurement in today's environment.

It poses a risk if materials prices aren't locked in early or contingencies aren't built into the contract, which can prove especially costly if a project is delayed waiting on components. Further, energy prices because of new geopolitical tensions have shot up in recent weeks with West Texas Intermediate crude jumping from just under $90 at the beginning of February to nearly $120 at the beginning of March. Prices continue to remain volatile as sanctions against Russian-produced oil are put into place.

In anticipation of these ongoing difficulties, contractors are using long lead times, price contingencies, escalation clauses, alternate materials, deeper alliances with distributors and subcontractors, and [warehousing](#) to ensure on-time project delivery.

The question is, how long will inflation endure, and what changes should we anticipate on spending behaviors and government policy.

"Developers should prepare to see higher bids and/or fewer contractors willing to bid on projects without price protection," Ken Simonson, chief economist at the Associated General Contractors of America (AGC), told FMI.

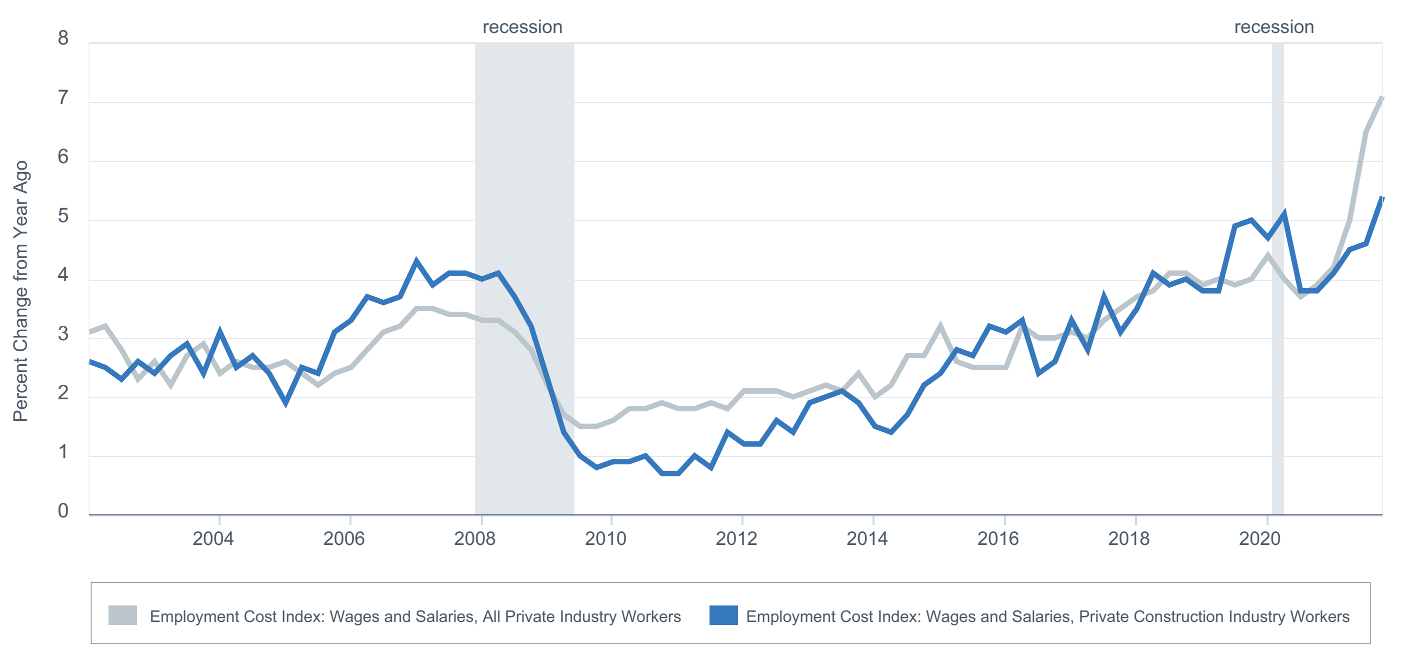
Currently, contractors are working to be transparent with owners about how uncertainty today affects project delivery in 12- or 18-months' time.

Collaborative relationships with subcontractors and a shared understanding among stakeholders on how changes in materials prices or lead times play out across a project allow contractors to respond to project challenges as they arise. These actions support a philosophy of shared risk in a time where the reallocation of risk and risk sharing is increasingly important for win-win outcomes.

Pushing risk down to subcontractors will ultimately increase the likelihood of future project challenges and failure. Owners and contractors need to work together in sharing risk so that no one party is saddled with cost escalations and all are positioned to deliver.

## Wage inflation and shortages of workers as construction demand rises

The tight labor market is not a new issue for the construction industry but will intensify as firms compete for skilled labor and wage inflation ripples through the economy. The construction industry appears to be behind the curve when comparing rising employment costs to the broader economy.




Source: U.S. Bureau of Labor Statistics

Sign-on bonuses and competitive salaries will be an important tool for recruiting and retaining top talent, while incentives like stock appreciation rights, long-term cash plans and phantom stock encourage retention over the longer term, and are common, according to FMI's 2021 Executive Compensation Survey.

Offering oversized compensation packages isn't sustainable in the long term, and FMI's results showed that firms are looking at their most crucial roles and determining how best to use financial incentives.

Firms are also thinking more creatively about how they can engage employees at risk of being poached by competitors and other industries. In construction, "We don't do a good job of talking about the tangible impact that doing this work has," says Anita Nelson, chief strategy officer at Skanska.

For people in the construction industry, the pandemic amplified the stress of what is ordinarily a high stakes field. In response, Hensel Phelps worked to spotlight and streamline access to mental health services offered through the company, educating supervisors and ensuring that it only takes one phone call or one click on the employee website to get help.

Many workers are also looking for flexible or hybrid working environments alongside higher wages to deal with increased living expenses or help with child care issues. We may see an increased outflow of workers from the industry if construction firms are unable or unwilling to meet these new demands.

However you achieve it, employee retention is crucial, since worker shortages can be found at every stage of a project.

In a fall 2021 survey of more than 2,000 nonresidential contractors, AGC found that 90% had openings for hourly craftworkers. Of those, more than 70% who were trying to hire a worker said the position was hard to fill.

The E&C industry needs to look at what it can offer early career trade workers, project managers, engineers and architects through senior leaders, since firms are not just competing for talent in an environment of wage inflation, but against other industries.

Contractors need to be strategic about plotting their paths forward and determining where to put their resources as the industry shifts.

## The big picture for economic growth

There is plenty of good news for the year ahead. Passage of the IIJA will create a huge wave of funding for nonresidential construction, alongside an already thrumming residential sector. But how strong is growth when you consider inflation?

The last peak for construction put in place spending in real dollar terms was the $1.16 trillion expenditure in 2006, equal to $1.49 trillion in 2020 dollars when adjusted for inflation, and above actual 2020 spending of $1.47 trillion. The industry remained below that 2006 peak in late 2021, implying that a good share of forecast growth is attributable to inflation.

Contractors need to be strategic about plotting their path forward and determining where to put their resources as the industry shifts. We know that about one-third of all construction dollars are spent in one of the largest 12 metropolitan areas. That means concentrated competition in key regions, while alternative delivery methods are being adopted on more projects and spending on megaprojects is projected to increase dramatically over the next five years.

In the years ahead, there are huge opportunities for growth. But in the near term, estimators will have a tricky job negotiating price fluctuations, supply chain issues, margin protection, labor costs and relationships with subcontractors.

Companies may experience a drop in profits despite strong backlogs and prospects for growth as energy and labor costs continue to rise. Having a buffer to absorb unexpected costs, communicating with owners and subcontractors more regularly, and evaluating risk more often can help mitigate the impact of the uncertain economy and operating environment.

# ABOUT THE AUTHORS

**Jay Bowman** assists a broad range of stakeholders in the architecture, engineering and construction industry. As the leader of FMI's Research and Analytics Practice, he develops data-driven, fact-based market intelligence to bring insights that catalyze exceptional company performance and competitive advantage. The research services he oversees include market sizing, forecasting, buying practices, preferences, competitive behaviors and response. He can be reached at ***jay.bowman@fmicorp.com*****.**

**Brian Strawberry** leads FMI's efforts in market sizing, forecasting, building products and construction material pricing, and consumption trends. He focuses on primary research methods, including the implementation and analysis of surveys and interviews. Brian also leads and manages various external market research engagements, and constructs tools and models for efficiently performing high-quality analyses. Brian can be reached at ***brian.strawberry@fmicorp.com.***

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## CONTACT US

RALEIGH HEADQUARTERS
223 S. West Street
Suite 1200
Raleigh, NC 27603

919.787.8400

**fmicorp.com**

## OFFICES

Denver
44 Cook Street
Suite 900
Denver, CO 80206
303.377.4740

Houston
1301 McKinney Street
Suite 2000
Houston, TX 77010
713.936.5400

Tampa
4300 W. Cypress Street
Suite 950
Tampa, FL 33607
813.636.1364