An Analysis of British Columbia's Industrial, Commercial, and Institutional Construction Sectors

PREPARED BY SAGE POLICY GROUP, INC.
ON BEHALF OF THE BRITISH COLUMBIA CONSTRUCTION ASSOCIATION

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A Sage Analysis

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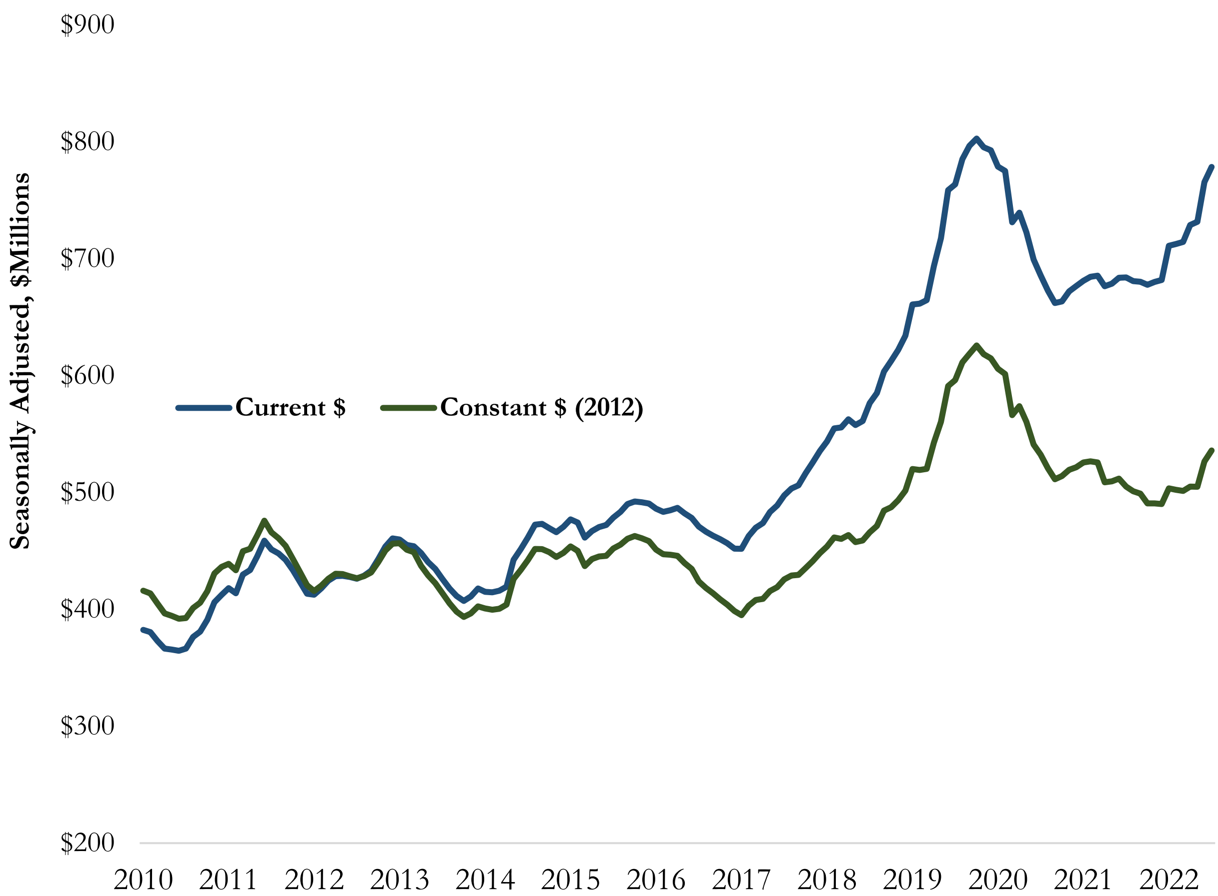
Macroeconomic Overview

INVESTMENT IN BUILDINGS HAS PLUMMETED

From the start of 2017 through February 2020, investment in industrial, commercial, and institutional/government construction in British Columbia surged, increasing 71.5% in nominal terms and 52.3% in real terms. Private investors and public policymakers were planning for good economic times that would consume more physical space. Then came the Covid crisis. Pre-existing momentum quickly evaporated. As of July 2022, ICI investment in British Columbia was up just 0.4% nominally but down 10.9% once adjusting for inflation relative to February 2020, the last month before widespread economic lockdowns transpired.

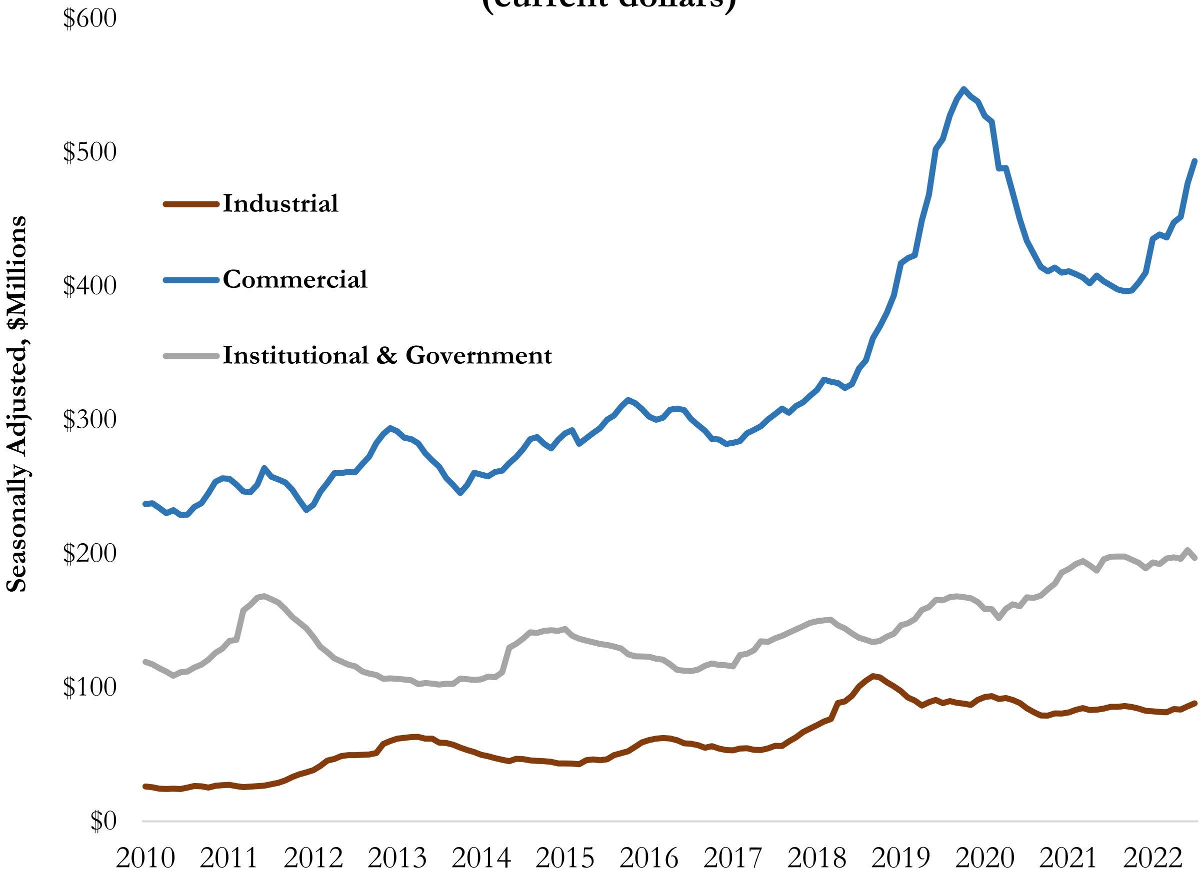
Investment in ICI Building Construction, British Columbia



Source: Statistics Canada. Table 34-10-0175-01 Investment in Building Construction

While the institutional/government segment has held up fairly well, investment in the commercial and industrial segments, which are more likely to be privately financed, has fared poorly in the context of remote work and other shifts in underlying economic behavior. Investment in the commercial and industrial sectors is down 5.6% and 5.8%, respectively, since the start of the pandemic.

Investment in ICI Building Construction, British Columbia (current dollars)

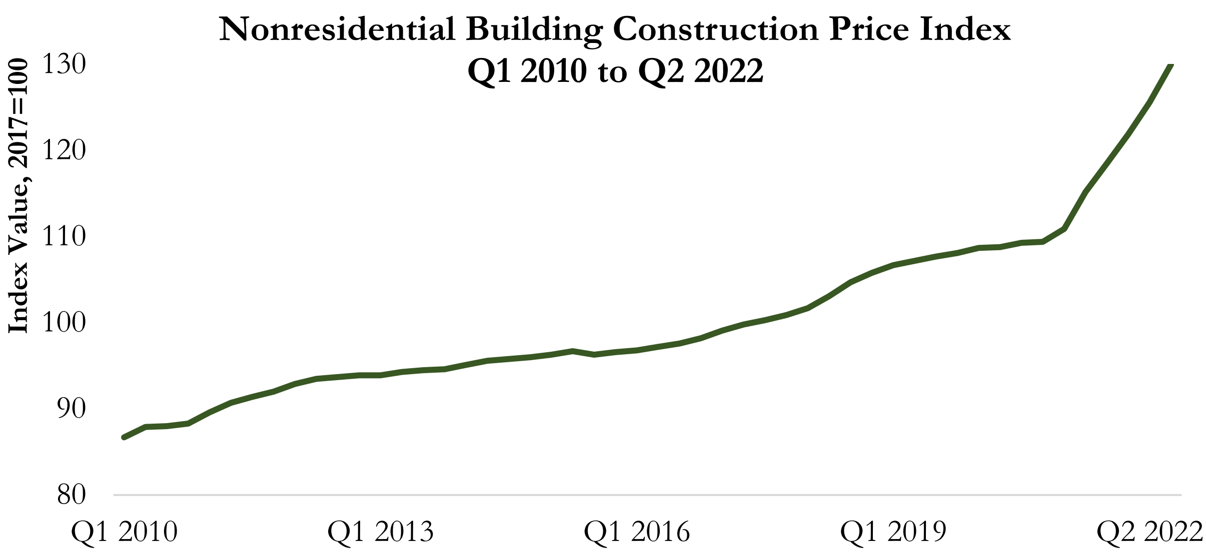


Source: Statistics Canada. Table 34-10-0175-01 Investment in Building Construction

Falling investment is attributable to numerous factors, including behavioral changes. Prior to the pandemic, commercial construction represented more than 67% of ICI investment in British Columbia. While the Canadian economy has bounced back in large measure, and national unemployment is incredibly low by historic standards, the way in which people use space has changed, and for the worse from the perspective of commercial construction investment. It may also be the case that the sharper decline in Canadian economic activity relative to the U.S. during the worst of the pandemic and a softer recovery has resulted in significant volumes of investment capital being redirected south of the border. Rising construction costs represent another factor. Among other things, materials and equipment prices have surged higher due to the combination of global supply chain disruptions and a relatively weak Canadian dollar.

CONSTRUCTION COSTS HAVE SURGED

From the first quarter of 2020 to the second quarter of 2022, a period encompassing 9 quarters, Statistics Canada's nonresidential building price index (a reflection of how much more it costs to construct a building) increased 19.6%, a greater increase than the aggregate economywide inflation observed over the eight years preceding the pandemic (+17.0% from Q2:2012 to Q1:2020; 32 quarters). Over the past year, the price of nonresidential buildings has increased 12.8%. By contrast, overall Canadian inflation stood at 7.6% for the one-year period ending July 2022. Construction costs were rising prior to the pandemic, but there was an inflection point in late-2020. The cost of delivering construction services has been skyrocketing ever since.



Source: Table 18-10-0135-01 Building construction price indexes, by type of building

MATERIALS PRICES UP MASSIVELY

Among the primary factors behind the unprecedented increase in construction costs is higher materials prices. Since the start of the pandemic (February 2020), prices for key inputs to the ICI sector have surged due to pandemic-induced supply chain issues as well as shocks to demand. For instance, prices for fabricated metal products and construction materials increased 43.6% between February 2020 and June 2022 according to Statistics Canada's Producer Price Index. All things being equal, higher construction delivery charges render it less likely that a given project will move forward. That helps translate into diminished construction spending even in the context of rising delivery costs.

The war in Ukraine didn't help. When Russia launched its invasion of Ukraine on February 24th, 2022, energy costs surged. While gasoline prices have been declining more recently, energy/petroleum, key inputs to construction, has become more expensive with prices up 72.7% since the start of the pandemic.

WORKER SHORTAGES PERSIST

Construction labour is as scarce as it has ever been in Canada relative to demand for workers. In July 2022, Canadian unemployment dipped to a record low 4.9%. In British Columbia, it was 4.7% that month.

The construction unemployment rate fell to 5.8% in 2021, the lowest level since at least 1976 (the first year for which Statistics Canada maintained data). The construction unemployment rate in British Columbia was an even lower 5.2%. That said, there have been times when provincial construction unemployment was even lower, falling at one point to as low as 3.8%. The provincial construction labour force stood at 259,500 in 2019. Two years later, it had shrunk by more than 12% to 227,700.

Source: Statistics Canada. Table 14-10-0023-01 Labour force characteristics by industry, annual

Over the course of the pandemic, British Columbia has accounted for 57.4% of Canada's decline in construction workforce, losing 31,800 construction workers from 2019-2021. Accordingly, provincial contractors had to rapidly increase wages to retain and recruit workers who would otherwise remain retired or supply effort to competing industries like logistics/shipping and manufacturing. Not coincidentally, average weekly earnings for construction workers in British Columbia were up 8.6% between February 2020 and May 2022, well above the 7.7% increase in wages for construction workers across Canada.

Additional Challenges

There have been other challenges, including those related to public policy.

PAID SICK LEAVE

As of January 1, 2022, employers in British Columbia are required to provide at least five days of paid sick leave to any employee who has worked for the organization for at least 90 days. Employers are required to pay their employees their regular wages on these days. The law applies to both full- and part-time workers.

This policy has further strained an industry already saddled with rising costs and acute worker shortages. This policy effectively represents a 2% increase in labour costs in addition to the measured cost increases approaching 9% between February 2020 and May 2022 that occurred in the context of diminished construction spending.

LACK OF PROMPT PAYMENT LEGISLATION

Despite industry efforts, British Columbia still lacks prompt payment legislation. The 2019 Builders Lien (Prompt Payment) Amendment Act would have required an owner to pay a contractor within 28 days of receiving a "proper invoice." It would have also required contractors to pay their subcontractors within 7 days of receiving payment from a project owner. The legislation did not pass, contributing to lingering financial uncertainty among contractors in the process. Ontario has had similar legislation in place since October 2019, Saskatchewan since March 2022, Alberta since August 2022, and Quebec is currently running a pilot project mandating prompt payment.

Because late payments can frustrate contractor cash flow while needlessly expanding financing costs, the lack of such policymaking creates greater probability of firm failure. When one firm fails, this can cause projects not to move forward. That in turn jeopardizes the existence of other contractors while resulting in an increasingly stagnant built environment.

With borrowing and other costs rising and the economic landscape increasingly treacherous, a majority of contractors (52%) are predictably concerned about prompt payment. Passage of prompt payment legislation in 2022 would supply greater certainty regarding contractor cash flow, thereby inducing additional hiring and perhaps setting the stage for higher compensation levels.

The ongoing lack of prompt payment legislation poses several risks for British Columbia's construction industry. It forces contractors to raise their bid prices due to higher risk mitigation costs, increasing overall construction costs and ultimately diminishing the volume of new construction.

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ELEVATED BORROWING COSTS

The Bank of Canada has raised its benchmark overnight rate to 3.25%, the highest rate among advanced economies. Monetary policymakers expect to continue to raise rates until excess inflation is quashed. Another motivation may be to keep the value of the Canadian dollar steady relative to the U.S. dollar. With borrowing costs marching higher, many project owners are likely to become reluctant to move forward with projects, putting pressure on already battered commercial and institutional segments.

A Risk Profile for a Typical ICI Contractor

According to research supplied by the British Columbia Construction Association, the typical contractor operating in British Columbia:

- Is relatively small—92% of construction companies in British Columbia report fewer than 20 employees;
- Has less than a decade experience; the median contractor has been operating for only 5-10 years, and therefore often remain fragile financially and otherwise;
- Is concerned about skilled labour shortages (80% of contractors);
- Is concerned about prompt payment (52% of contractors);
- Are increasingly less likely to recommend a career in construction (69% of contractors); and
- Offer employee benefits (91%) and have raised wages in 2022 (76%).

Levels of concern vary by firm size. Large companies (those with more than 100 employees) are more likely to be concerned about skilled labour shortages due to higher turnover rates among their workforces. Labour shortages are not a new phenomenon, but they have worsened in recent years in British Columbia. In 2015, 70% of contractors surveyed by BCCA reported difficulty sourcing skilled labour. By 2022, that percentage had risen to 80%. Nearly a third of the industry workforce (32%) has taken a new job for more pay over the past year. In short, retention has become more challenging, and recruitment has become far more expensive.

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Smaller companies are more likely to be concerned about prompt payment legislation since smaller firms tend to have more limited cashflows and less access to flexible financing. One BCCA member explained that "lack of payment has crippling ramifications for not only our business but tradespeople, suppliers, industry professionals and the community at whole," while another lamented that "nothing keeps me up at night except customers that don't or won't pay bills on time."

Conclusion

Elevated demand for one's services can obfuscate a significant amount of underlying vulnerability. After many years of rapid economic expansion, British Columbia's construction community now faces a different set of circumstances, including diminished construction activity amidst rising project financing costs, shifts in behavior that have negatively impacted key commercial, institutional, and public segments, equipment shortages, surging materials prices, and skilled worker shortages, and it is unclear whether or not the industry is suitably prepared.

These challenges are being compounded by a lack of supportive policy intervention. Risk of recession remains high, which also means that timely payment from project owners or other contractors is becoming less certain in an environment in which prompt payment legislation failed to pass. Absent policy intervention like prompt payment legislation, British Columbia may experience significant contractor failure during the quarters ahead, which would further compromise industry capacity and drive construction delivery costs even higher.

About Sage Policy Group

Sage Policy Group is an economic and policy consulting firm headquartered in Baltimore, MD. Dr. Anirban Basu, Sage's chairman and CEO, founded the firm in 2004. Over a period spanning nearly two decades, Sage has created a client base that encompasses more than forty states and seven countries and includes Fortune 500 companies, professional sports teams, aquariums and zoos, state and local governments, insurance companies, banks, major medical systems, trade organizations, and law firms, among others.

The company is especially well known for its expertise in construction economics. Dr. Basu serves as the chief economist for several industry organizations, including Associated Builders and Contractors, the Construction Financial Management Association, MARCUM Construction Accounting, the Modular Building Institute, and others. Dr. Basu and the Sage team have written extensively about Canada's construction industry, including in a bimonthly newsletter for the International Finishing Contractors Association.

Dr. Basu's lectures in economics are delivered to audiences across North America. In recent years, he has focused upon construction economics, health economics, the economics of education, and economic development. He has lectured at Johns Hopkins University in micro-, macro-, urban, and international economics, and most recently, global strategy and currently teaches a history of economic thought class at Goucher University. He has been interviewed by CNBC, CNN, Fox Business, Axios, the New York Times, and many others.