

# Construction deflation's impact on project cost estimates

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You are probably missing out on some projects of your desired scale if you are using the same dollar search range that you set several years ago in [Connect](#) or in another project news service.

Construction project costs can change as much as 10% or more over as short a period as six months, which is long enough for the economic, construction or materials price cycles to shift to a distinctly different demand/supply balance. Price cycles typically last four years. Beginning at the bottom of a cycle, market conditions and hence pricing, improve for three years and then worsen for a year, returning to the cycle's low point.

Construction project pricing over a four year cycle changes with the demand/supply of resources used in a project and fluctuations in the macroeconomic cycle that set the level of resource demand. Cycle timing is different in each small market. Although each market goes through the same four year cycle, the cycle begins and ends at a different point in time in each market. The relevant cycle for each contractor is the weighted sum of the cycles for each resource he uses in his project work.

The resources are the labor, materials and equipment specialized for each type of project, plus resources used generally in all types of construction and elsewhere in the economy. The difference in cycle timing for different resources used in a project usually means that some of the cycles are offsetting. For example, at a given point in time, lumber demand and prices may be at a cyclical peak while design, labor or metals may be near the bottom of their cycle, showing very weak pricing.

Project pricing can change very quickly when most of the cycles for the resources used in a project and the general economic cycle that sets the demand level are near the cyclical peak (bottom). Note that this happened in the nonresidential building market from late 2007 to early 2008. Project pricing, including contractors' margins, increased very rapidly, more than 10% in a six month period. Similarly, the weakest project pricing in the current nonresidential building cycle is likely to be in late 2009 and early 2010.

Consequently, contractors searching for projects of the right scale for their capabilities need to periodically adjust the dollar range of their searches to ensure that they keep finding projects of the same scale. Suppose a contractor identified early in 2007 that the ideal scale for his capabilities was a \$10.0 million project. The pricing of similar projects began increasing early in 2007 with a strong [economy](#) spurring project starts and rapid economic growth worldwide pushing prices upward as resource demand rose faster than suppliers could respond.

The \$10.0 million project probably rose to well over \$11.0 million by early 2008 with some individual projects estimated at \$12.0 million or more. Then, project pricing gains stopped in mid-2008 with declining prices, likely to decrease for another six months. The \$10.0 million project probably will drop to near \$9.0 million by the end of the year with other projects falling well below \$9.0 million as contractors seek work to keep their staff on board for better times to follow.

Unfortunately, all project owners and their cost estimators do not estimate project costs the same way. Every month similar projects go to bid with vastly different cost estimates. As a rule of thumb, assume that cost estimates attached to a request to bid are at least three months out of date. Some cost estimates, especially for public projects, are as much as a year out of date.

Contractors should set their dollar search range based not on what they would bid but on what project owners estimate. Contractors who bid both public and developer-financed projects need a wider search range than contractors that bid only public or only private projects.

If a contractor is currently finding projects of the desired scale with a \$5-10 million search range, the scale should be lowered — at least the lower limit — as much as \$1.0 million by next spring to accommodate weaker project pricing as we drop to the bottom of the construction cycle. Then the range should be progressively raised — at least the upper limit — over the next three years as space demand, design costs, jobsite labor, materials, contractor profit expectations and equipment rental increase during the next up phase of the cycle.