PROJECT & INFRASTRUCTURE ADVISORY

BDO OUTLOOK: ECONOMIC AND FINANCIAL MARKET FACTORS

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INTRODUCTION

Australia is experiencing some incredibly challenging macro-economic conditions centred around inflationary pressures. Although there are promising signs that these recent pressures have peaked, both in Australia and globally, the return to the Reserve Bank's target inflation band is not expected to happen until the 2024-25 financial year.

The negative effects of high inflation and increased interest rates has resulted in increased costs of borrowing for consumers and businesses, reduced purchasing power, competitiveness, lower standards of living and increased economic uncertainty. There isn't any doubt that elevated inflation and poor wage growth plus the rapidly tightening financial cycle are causing pain for many households, consumers, businesses, and impacting financial markets in Australia.

High inflation has also made it harder for businesses to plan, with owners spending their time protecting organisations against inflation rather than investing in productivity improvements which has impacts on wage growth further down the line. Many businesses are currently facing an extremely difficult environment with unique challenges depending on the industry sector they are in.

In inflationary environments, the value of money is diminished. Organisations must earn a higher rate of return to break-even. The last few years have been challenging for organisations both locally and internationally. CBDs have been deserted due to the work from home phenomena, rising costs have resulted in insolvencies, and Australia has experienced productivity issues. However, it's not all doom and gloom as Australia is a very resilient country with a resilient economy. In particular, our mining industry and commodities have held us steady during these trying times. This resilience is the key to achieving success in the next 12 months and will set businesses up to survive and thrive across key challenges facing Australian industry sectors.

This guide explores the key economic challenges across the technology, healthcare, construction, real estate, financial services, professional services, family-owned business and international business sectors.

SECTOR ANALYSIS

TECHNOLOGY SECTOR

The technology sector has experienced a downturn driven by post-pandemic inflation and rising interest rates. Large-scale digital transformation projects were some of the first to be put on hold by clients of tech businesses, as costs began to rise. This has led to customer attraction difficulties as businesses have trimmed spending. Added to that has been staffing issues exacerbated by the tight labour market, in an industry where staff retention rates are typically low.

BDO comment: We hope that industry retention rates will return to a healthy net as an increase in skilled overseas migration alleviates some of the labour market shortages.

HEALTH SECTOR

The health sector remains in a strong position despite economy uncertainty, as this sector tends to perform well due to its necessity. However, healthcare organisations are struggling with the costs of doing business. Staffing challenges as well as inflation increasing prices are impacting all areas of the sector, which has led to higher healthcare costs for patients.

BDO comment: Healthcare organisations need an increased focus on cash flows to ensure profitability and sustainability. Businesses in the sector can increase scrutiny of financial data to highlight areas of weakness and opportunity to remain profitable. Leveraging technology is also a mechanism to improve efficiency and levels of productivity. This includes automating systems and adopting med-tech innovations such as telehealth or newer health devices to support patients and expand business. The sector is also increasingly falling victim to cyber-attacks so investment in cyber security is a wise move.

CONSTRUCTION SECTOR

The construction sector has faced considerable stress in the past 18 months, driven by the increased cost and limited availability of materials. Fixed price contracts have worked against the industry, which has experienced a record number of insolvencies, impacting both consumers and the broader market. Productivity in the sector has been an ongoing issue, which is lower than it was in the 1990s. The industry sector is also facing record labour market shortages.

BDO comment: Organisations in the sector will need to assess how they approach fixed price contracts going forward, as these may expose businesses to unacceptable levels of risk in terms of costs. For businesses seeking to become more sustainable, there are several financial incentives that can be leveraged.

REAL ESTATE SECTOR

With rising interest rates comes the fear of the housing bubble bursting. As such, the current housing market is facing uncertainty, particularly for people on fixed rate mortgages and renters. According to some surveys, nearly half of Australians have lost the motivation to save, invest or increase their income and there has been a marked impact on household savings which were accumulated during the pandemic. There have been uneven impacts across the population when it comes to household financial pressures, with those in younger aged households experiencing the most pain in terms of housing. These were the people impacted by the first homebuyer incentives and are now the households that are seeing their mortgage rates almost triple. As a result, these households are now focused on survival rather than building wealth which may have impacts later when it comes to retirement.

BDO comment: While inflation has had impacts on housing demand, housing itself influences inflation. The housing component of the Consumer Price Index (CPI) is given the biggest weight of all goods and services. This reflects the relatively large expenditure households put towards housing costs. As a result, inflation is heavily influenced by changes in rents, new dwelling prices and utility costs. The annual change in the total housing component of the latest CPI figures was 9.8 per cent and the main contributor to the annual rise was new dwelling purchases followed by utilities.

We've seen rental growth continue to pick up in all capital cities with the rises, driven by the tight rental market and low vacancy rates across the country. Rents have risen 4.9 per cent annually which is the highest annual rise that Australia has experienced since 2010. Mortgage holders are likely to feel more of a pinch in their household budgets with rising rates adding significantly to mortgage costs at high debt levels, and households may find it difficult to fund these costs. As a result, discretionary spending is likely to shrink more over the coming months.

The most notable indirect impact of rising inflation on the housing market has been the subsequent increases in the tax rate and this is because the RBA aims to influence inflation using the cash rate settings. The RBA targets a measure of core inflation which actually strips out to the shorter-term volatile influences on the CPI. Annual core inflation is currently tracking at 4.5 per cent. Given that's unusually high and with the unique emergency cash rate settings during the pandemic, we're now expecting to see the RBA lift the cash rate again, probably at least twice more, which will influence the housing market yet again.

FAMILY-OWNED SMALL TO MEDIUM ENTERPRISES (SMES)

Family-owned organisations and small businesses in Australia are facing difficult situations as they try to balance rising expenses with the need to retain customers. Customers are diverting their spending away from non-essential goods and services to cover the increasing cost of living leading to a decline in demand for discretionary goods. As a result, small business owners are finding themselves in a difficult position, with a need to increase prices to cover rising costs, while avoiding driving customers away.

BDO comment: : Inflation does unfortunately have a profound impact on small businesses and influences their decision making in numerous ways. To mitigate risks and challenges, small business owners may opt to cut back on certain expenses which can include:

- Delaying new product launches
- Cutting back on marketing spend
- Repairing equipment rather than investing in replacing
- Terminating certain product or service offerings that are no longer being purchased
- Cutting travel expenses
- Switching to more cost-effective materials.

The willingness to take on financial risk may be reduced as small business owners generally focus on weathering inflationary storms and trying to maintain profitability. To remain competitive in the market, family-owned organisations that embrace technological advice advancements and invest in digital transformation are well placed to adopt information to better their business processes.

INTERNATIONAL BUSINESS

Global inflation is expected to wane in 2023 as supply chain disruptions and demand normalise. However, if inflation in the United States (US) and globally remains high, monetary tightening may be more aggressive than currently expected.

BDO comment: It is a promising sign that the current US cash rate was recently kept on hold. This does pose a downside risk and has the potential to rattle global financial markets, lowering demand for, and certainly lowering the prices of, resources, energy and agricultural products. Higher US interest rates may also lead to capital outflows and currency depreciation in emerging markets that raises economic and financial instability in some of our largest export partnerships.

Our commodity exporters have benefited from high global prices and our resources and energy exports are forecast to reach $311 billion this year. However, labour market shortages have put upward pressure on wages along with higher global shipping and imported goods prices, contributing to cost pressures in several sectors across mining, manufacturing, transport and agriculture. Given Australian organisations, especially small to medium-sized operators, have limited scope to raise prices, we're seeing increased squeeze on firms profit margins. Global growth is expected to remain below average over the next couple of years.

ECONOMIC OUTLOOK — FINAL COMMENTS

There are several challenges currently impacting our industry sectors.

Labour market challenges are expected to alleviate with the influx of more skilled migrants as a result of borders reopening and the government taking steps to increase our planning numbers and the number of visas being issued.

The inflationary pressures are continuing but are expected to ease through the latter part of this year and certainly settled by 2025.

Innovation improvements and technology are the key focus areas for organisations to consider in order to overcome and thrive in the current economic conditions. Looking at ways to increase efficiency and productivity will be key to navigate the financial challenges that we are seeing.

ABOUT BDO

With significant experience providing economic advice on infrastructure projects, our project and infrastructure advisory team comprises some of the most trusted economic advisers in the market.

It is important that robust economic analysis is undertaken to inform decision making and we use a number of economic tools and techniques including:

- Macroeconomic outlooks
- Cost benefit analysis
- Economic impact analysis
- Demographic forecasting and analysis.

Contact us to learn more about our economic advisory services.

DARREN BLACK
National Leader, Project & Infrastructure Advisory
darren.black@bdo.com.au
+61 7 3237 5715

ALLY FLINT
Partner, Project & Infrastructure Advisory
ally.flint@bdo.com.au
+61 7 3173 5443

ANDERS MAGNUSSON
Partner, BDO EconSearch
anders.magnusson@bdo.com.au
+61 8 7324 6192

1300 138 991
www.bdo.com.au

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23-06-0978