Soaring gas prices will raise the cost of some building materials

The construction sector has already faced high prices for timber, steel and plastics this year. Due to skyrocketing gas prices, prices of energy-intensive building materials like concrete, cement and bricks will rise too, though at a slower pace

Construction workers in Budapest, Hungary

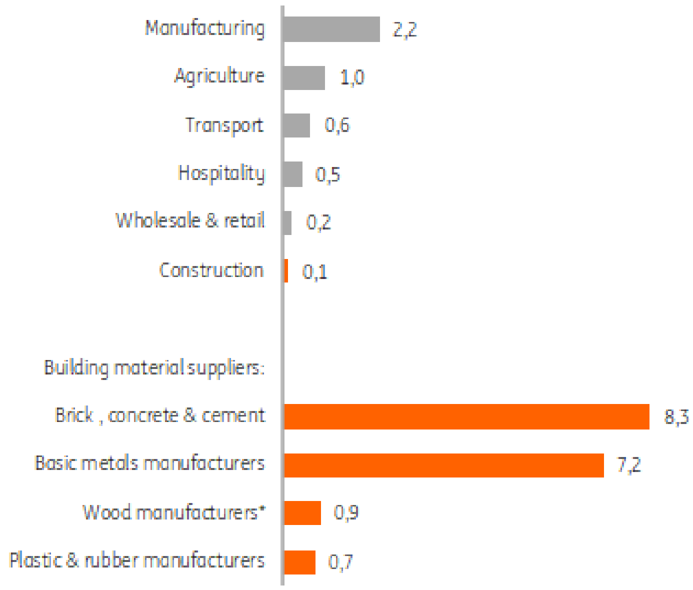
Energy markets are likely to remain tight in the coming months, especially if the European winter turns out to be cold. EU leaders are increasingly saying that the situation has become 'unbearable' for households and businesses. In a recent article, Gerben Hieminga and Warren Patterson analysed policy options, but concluded there is no panacea. So what does the high gas price mean for the construction industry?

Contractors don't use a lot of gas

Rising gas prices increase production costs for several industries, but manufacturing, agriculture (eg. horticulture) and transportation are particularly large users of natural gas. In comparison, the construction sector is not very gas intensive. In fact, sectors like wholesale, retail and hospitality are more reliant on this fossil fuel.

Contractors use little gas, producers of building materials use a lot of gas

Use of terrajoule natural gas per € 1 million value added output, 2018



Source: Eurostat & ING Research, *estimate

Brick factories and the concrete and cement industry are energy intensive

While contractors don't use a lot of natural gas in the building process, that doesn't mean they are not impacted by rising gas prices. Suppliers of metals, bricks, concrete and cement are heavy users of natural gas. For instance, gas can easily account for one-third of the cost of a brick factory, as heating is an essential part of the production process.

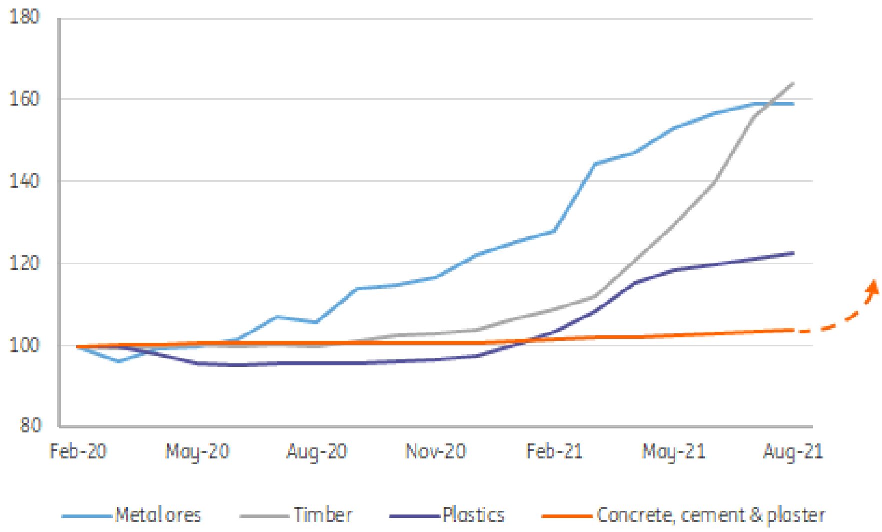
> *"French building material firm Saint-Gobain last week said it is expecting €1.5 billion of materials and energy cost inflation compared with 2020. That adds €400 million to its previous estimate from July, mainly due to the cost of energy in Europe"*

Pass on the price

As we explained in our last article on building material prices, the "price through" of procurement prices in the markets for concrete, cement and bricks is rather slow as there is relatively low competition. This is due to the characteristics of these materials. They are large and heavy and consequently difficult and costly to transport. Therefore, concrete, cement and bricks are primarily traded on local markets. This gives the suppliers of these products more market power, which generally results in relatively higher prices but consequently also in lower price volatility. As a result, output prices of these industries decrease but also increase at a slower pace compared to timber and plastics. This is one of the reasons why we haven't seen strong price hikes in cement, concrete and bricks, yet.

Concrete & cement prices will increase

Producer Price Index, Index February 2020=100 in the European Union



Source: Eurostat, ING Research

The next procurement price increase: cement, concrete and bricks

Despite the slower pass-through of procurement prices (including gas prices) for concrete, cement and bricks, the boom in gas prices will eventually make its way through these markets, which are very energy intensive. Therefore, contractors will have to prepare themselves for a phase of rising prices for building materials. The only "positive" thing for them is that the increase will probably be slower compared to plastics and timber.

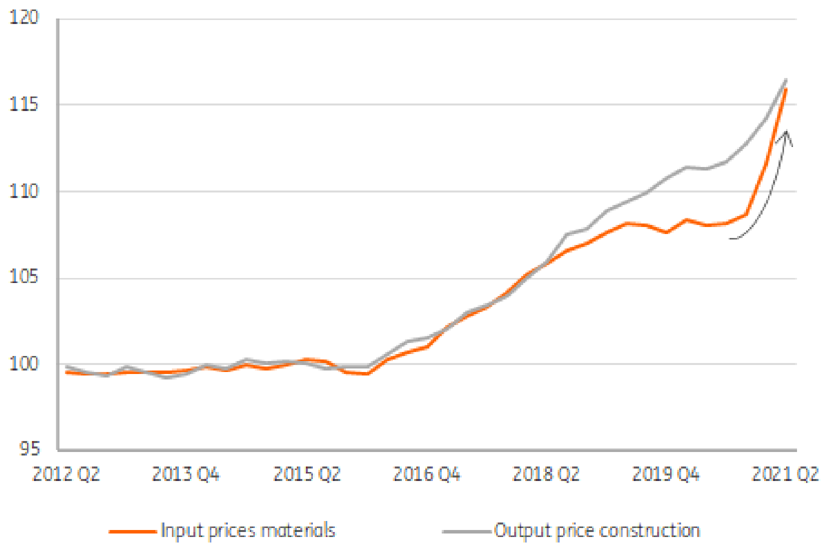
Contractors' margins are diminishing

Building companies' profit margins have already come under pressure due to price hikes in timber, plastics and metals. These rising costs can easily lead to loss-making projects, as profit margins are thin in the construction sector, generally about 2% to 4%.

Output prices of construction projects and input prices of building materials are, in general, closely related. However, from 2018 until the end of 2020, contractors' output prices increased faster than input prices, which could have resulted in higher profits. Now, input prices are catching up quickly, having seen the biggest increase in the first half of 2021 since 2004.

Contractors input prices are catching up

Construction prices new residential buildings, Quarterly data Index 2015=100, European Union



Source: Eurostat, ING Research

The construction sector is already struggling with substantially higher timber, plastic and metal prices. Increasing costs of concrete, cement and bricks will add more pressure to already low margins and could also lead to new supply chain disruptions if suppliers are forced to reduce production. This could lead to shortages and delays in the building process. To cope with price fluctuations, contractors will have to closely follow the price movements in building materials and use hedging policies to minimise losses.

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