THE EFFECT OF RISING CONSTRUCTION PRICES

BY STEVE BERGSMAN | SPONSORED BY SIOR FOUNDATION

The official inflation rate for the United States in 2018 was a very modest 2.1 percent and expectations are that general prices will rise just 2 percent this year. Commercial real estate brokers have a right to be suspicious of these numbers because the quantum leap in the pricing of land, materials, labor, and rents has made their jobs much more difficult.

Pick a City— Any City.

In Dallas over the past six and a half years, construction prices have jumped 22 percent, reports Grant Pruitt, SIOR, president and managing director of Whitebox Real Estate, Dallas. In Indianapolis, rental rates that used to be $18 to $19 per square foot five years ago are now $23 to $24 per square foot, observes Tim O'Brien, SIOR, president of O'Brien Commercial Real Estate, Indianapolis. In Houston, construction costs vaulted approximately 8 percent in just one year, declares Travis Land, SIOR, a partner with NAI Partners, Houston. In the Research Triangle area of North Carolina, construction costs and rental rates have risen 25 percent to 30 percent in the last 12 months, notes Street Jones, SIOR, principal with Rich Commercial Realty, Raleigh.

Then there is the situation in Salt Lake City.

"What we have found in Utah over the last 12 to 18 months is that the rising cost of construction is no longer running parallel with the current lease rates on new product," says Chris Falk, SIOR, principal and executive vice president at Newmark, Salt Lake City. "Essentially, rising construction costs are beginning to out-pace lease rates for Class A office buildings."

In Salt Lake City, the demand for space had been on such a tear, almost anything could get financed. The sharp increase in construction costs has changed the equation, says Falk. "Through transactional experience and in speaking with other local brokers, it's become clear that many institutional lenders that were always OK with spec projects in the past have taken a more conservative tack. They are concerned lease rates are not increasing as fast as construction costs, [and] that there is a delta, growing daily, between where leases need to be to keep up with the cost of construction."

Other problems endemic to construction costs have surfaced as well.

After the economic downturn of 2008-2009, a lot of workers left the industry. So, when things started to boom again, there weren't enough people to hire and that resulted in higher labor costs, explains Barbara Johnson, SIOR, first vice president of CBRE, Salt Lake City. "At the same time, the cost of materials increased—some of it, like steel, because of tariffs."

It's a Balancing Act

So, what happens when all of those costs increase? Johnson gives the example of tenant improvements, which has become a tightrope walk.

"It's been a real challenge for landlords, because if they stayed at the same percentage level of the past, the return on investment would shrink markedly due to the costs of building out the tenant improvements," she explains. "So, landlords are sticking to tight budgets for tenant improvements, which means the tenant will have to come out of pocket for additional costs."

The compromise offered by the landlord is for the tenant to increase the length of the lease from—for example—five

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years¬ to seven or eight years. Then the landlord will pay for the overage and amortize that cost over the extra years. The problem is, in Salt Lake City, tenants are generally tech companies who want to preserve capital to hire the best talent, and—because these companies are expanding rapidly—don't want to have a longer lease.

The Compromise Solution

"The tenants say, 'If I have to commit for eight years, I would like to be able to terminate after five years, paying a penalty for the remaining tenant improvement dollars not yet amortized as well as the leasing commission for the remaining years'," says Johnson.

The situation is not very different in Dallas, where Pruitt says, "the cost of construction to get any sort of space [that] people would like has outstripped the appreciation of the rent. We used to be able to get carpet for $1.50 to $2 per square foot and pay $1.50 to $2 per square foot for two coats of paint. Today, we are looking at $5 to $10 for carpet and another $5 for paint."

Pruitt adds, "Seven to 10 years ago, we got $50 per square foot in tenant improvements and we could build out the Taj Mahal. That's not the case anymore. Not only have costs increased but in the war for talent, the tenant demands higher quality space than 10 years ago."

All of this means that the tenant now has to come out of pocket to accommodate the needed finish, which has become an impediment to getting deals done. The compromise solution is for the landlord to pay for the more expensive tenant improvements but take a longer lease deal so as to amortize the expenses.

"There is a misconception that lease terms are getting shorter," says Pruitt. "But, a recent study of our market shows leases are getting longer because savvy real estate brokers realize negotiating a longer lease will allow the landlord time to amortize the more expensive tenant improvements."

In economic terms, an increase in construction costs needs to be assimilated into the financial terms of the deal, explains O'Brien. "Generally, the landlords aren't eager to absorb additional costs resulting in lower returns, so the result is upward pressure on rental rates or longer lease terms so as to accomplish a longer amortization period."

As in Salt Lake City, fast-moving tech companies elsewhere in the country have a way of changing the equation.

"In regard to our existing client base, I would estimate over half of our clients are in growth mode and actively discussing expanding," says Jones. "The rising costs are putting pressure on tenants and affecting the way we approach deals. Twenty-four months ago, a tenant in our market who was going to up-fit a space from shell condition could build that space out for $60 per square foot. That number is now $85 to $90. That poses a challenge for a high growth companies, like tech firms, that want nice space, compete for talent, and expect to increase head count."

These kinds of companies don't want to sign long-term deals.

"They are comfortable signing a five-year deal but don't want a lease for too long, which could inhibit operations or growth," says Jones. "What we try to do is focus on maximizing the tenant improvement allowance, but it no longer covers the total hard cost—so tenants are forced to cover the delta. We have several tenants right now who are getting financing to do improvements. They have to do shorter term deals and that is the way to bridge the gap. Luckily—for now—interest rates are still low."

The tenant improvement allowance is only going but so far and the difference is needing to be made up by tenants, says Jones. "In the past, the difference could be bridged one of two ways, by the tenant out of pocket or by the landlord through the addition of a lease term, but operationally, many of our tenants don't want the longer term."

For brokers, it's important—in advance discussions—to ascertain tenant goals versus what the landlord will probably end up doing.

"The tenant who is working with a sophisticated advisor will get a sense of market conditions," says Johnson. "Tenants have to know the landlord will no longer build-out brand-new space for a five-year term; they will have to commit to a longer lease or find a space that is not going to require a lot of improvements."

This is especially true for smaller tenants, who must balance build-out requests to what they can actually lease that will not require a lot of tenant improvement dollars.

"Landlords are not willing to give a lot to a small tenant, nor is the small tenant willing to come out of pocket," says Johnson. "That lengthens the process because you are now not only looking for a good location but also for space that doesn't require a lot of TI dollars."

Build-to-Suit Developments Face Similar Issues

Houston currently boasts 15 million square feet of industrial space under construction—25 percent of which is pre-leased or built-to-suits.

As noted, the construction costs have risen 8 percent annually and industrial land prices are rising as well, says Land. "The total package for new projects is significantly higher, so if end-users want to own, they will have to leverage more because the costs have increased."

Developers are going to keep the same level of margin required for their specific rate of return, Land says. "As a result, on spec projects, the asking rental rate required to make the project work is increasing proportionately."

If tenants don't have a very specific requirement, they need to look for other facilities that can be retrofitted versus building new, Land continues. "Tenants will need to [either] go smaller or find second generation space. I have not seen new projects scaled back because of higher construction costs, but instead, what I have seen are tenants changing to existing space. Tenants, who were dead set on building new, once they received the pricing, decided to focus on existing options that were more cost effective."

Going back about a year, Land was in the process of getting bids to build a 120,000 square foot, Class A building, when the owner/tenant was hit with sticker shock.

"As we were making the decision on how to value-engineer the project to reduce bells and whistles and save some money, we did one more market review," Land recalls. "An existing building showed up in our survey with a 30 percent savings compared to ground-up. We had land under contract and were negotiating with builders, but the project was becoming too expensive. The client was very happy that we found a cheaper alternative."

Pruitt was recently working a deal for a 400,000 square foot build-to-suit involving a national search, when his client contacted him on a Friday and said, "Chinese tariffs will be coming into effect on Monday." Pruitt's client realized by three that afternoon he could buy the steel at that day's prices before it went up 22 percent on Monday.

Pruitt shares, "We hadn't even signed the lease and my client bought the steel that afternoon, telling us, 'If we don't do the deal with developer, worst-case scenario, we'll just sell the steel to someone else'."

With construction and rental costs rising so quickly, brokers and tenants need to be creative—and sometimes fast on their feet or the market will move out from under them before they realize it. ∇

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