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Thinking Outside the Box to Cope with Rising Construction Costs

By Steve Bergsman

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The price of all items needed to put up a new building has increased exponentially over a very short period of time—throwing off job estimates—and in many cases making new construction untenable.

The word *steel*, for example, now evokes a visceral reaction because of higher prices.

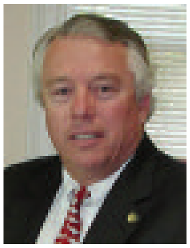
"We are now bidding on a building with the identical design as one we put up a year ago and the price of steel has gone up 47 percent since then," exclaims **Donald C. Land, Developer Associate,** Balke Brown Associates, a St. Louis, Missouri, developer, broker, and property management firm.

However, it is not just steel that is going up in price. It is also other materials such as asphalt.

"The biggest increase we have probably seen has been asphalt, up 70 percent in less than a year," notes **James DiNapoli, Developer Associate,** with the Galesi Group, an Albany, New York-based commercial real estate developer, owner, and management firm.

On top of all that, municipal regulations are adding to costs, going Green is more expensive, and financing charges have spiraled upward.

"Entitlements are getting more difficult, time-consuming, and



expensive," reports **Kevin C. Geenty, SIOR,** a Principal in the Branford, Connecticut-based The Geenty Group, REALTORS. "It took us 13 months to get a permit for a building totally in compliance with all zoning and wetland codes," he notes.

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Meeting the Price Point in Leasing

The higher expense of building would not make much of a difference if developers could then lease space at a price point where there was sufficient yield. The problem in most U.S. markets today is that it is not possible. Because of high vacancies and competitive pricing, new construction does not "pencil out."

"It costs a lot more today than it did 12 or 24 months ago to do the same building," says **John Barker Jr., SIOR,** an industrial specialist with Red Rock Developments in Charlotte, North Carolina. "You are seeing rents move up 20 percent but that does not offset the 60 percent increase in building costs over the past 24 months. And it is hard to convince a tenant to pay $4.50 a square foot when the market rate is $3.85."

"It's hard to get these buildings to pencil out right now," adds Land.

That begs the question: can anything be done to deflate the cost of building a new structure so as to make it competitive in a local market? The short answer: not much. However, there are some better management techniques, opportunistic tactics, and even a few out-of-the-box solutions.

In fall 2007, Balke Brown boasted five projects going up at the same time. One year later, four were completed and one was still under construction. Balke Brown was able to hold the line on construction costs because it bid out the contracts and locked in pricing "more than a year ago," says Land. "We are locked in on pricing; meanwhile the contractor that I work with says that construction costs have gone up at least 10 percent."

If you have a tenant and are fairly certain you can nail down a construction schedule, then bidding out early is one solution to the problem of rising prices.

"You buy down the risk through subcontractors," adds **Larry Longman,** Vice President of Preconstruction with Lauth Property Group, an SIOR Developer Associate firm in Indianapolis. "Essentially, we will publish a schedule with every project and the date we intend to do a particular activity. Take for instance a 500,000-square-foot warehouse in Indianapolis. We will tell the asphalt sub that we will pave the new parking lot in May 2009 and it is his responsibility to give us a value today. It is the equivalent of

hedging the risk. The sub may buy a futures contract to buy down his own risk."

That being said, don't be surprised if the subcontractor comes back to you with open hands because the price increase in materials far exceeds the original estimates. At the end of 2007, Lauth broke ground on a project in a mid-western market. The firm bought the complete site-work package, including asphalt, prior to beginning construction. "We felt that we had bought out the risk," says Longman. "However, our asphalt vendor came back to us and said the material price had gone beyond the threshold he could have anticipated and was seeking additional reimbursement." Although the contract absolved Lauth of any obligation to absorb additional costs, an amicable solution was negotiated to show good faith.

"Although holding to our contractual rights would have been a win for us, it would not have been a win for us next year if the asphalt vendor was not around," says Longman. Ultimately, Lauth gained a favorable financial position in the end while enhancing a subcontractor relationship.

Using Alternative Materials to Minimize Costs

Another solution to the problem of higher prices is alternative methods and materials. In some parts of the country, tilt-built structures can be put up only during certain months of the year. To save time, which in the end saves money, consider precast buildings as an alternative.

"In the South, we have good weather and we can do tilt-built all year around," notes Barker. "Nevertheless, the pricing for precast today is very comparable to that of tilt-built and you will find some savings in your construction costs because it takes less time to build. Even if it costs $100 a panel precast and the same tilt-built wall costs $75, completing a structure a month early on a nine-month construction project, could save millions of dollars."

Barker was not the only Southeast developer with precast on his mind. "We had a built-to-suit assignment with ITT Corp. for a manufacturing facility," recalls **R. Milton Thomas III, CCIM, SIOR,** a Principal with Anchor Commercial/ CORFAC International in Charleston, South Carolina. "The problem was that with increased costs there had to be some kind of improvement in rental rates that tenants were willing to pay. At the end of the day our margins were going to be squeezed."

Trying to figure a way to cut costs, Anchor decided to price a precast building, which for the most part, takes steel out of the construction process. "Since the local economy has cooled off, we are beginning to see some reductions in construction materials offered by manufacturers," says Thomas. "The precast manufacturer gave us very competitive pricing. Basically, it got the cost down to a point where we could be competitive on rental rates."

If a tenant asks for 60 feet of concrete in the truck court, can heavy-duty asphalt and a dolly strip do instead? Does the loading dock need to be 60 feet—or can it be 50?

Paul A. Waters, CCIM, CRE, FRICS, SIOR, a Senior Managing Director for CB Richard Ellis in Dallas, who does tenant representation, points out that to get some build-to-suits completed, tenants tend to be flexible. "The tenant improvement dollars are the same, but what you may get is a lot less quality," he says. "You may get cheaper 2x2 panels, lighting, or even doors. In effect, it is the same tenant improvement but with a cheaper build-out."

Even from the developer's point of view, flexibility in regard to alternative materials and systems is essential in today's difficult economy. "Traditionally, for a 500,000-square-foot warehouse, we would buy a ballasted-roof membrane system, which is insulated by a product called polyiso that is petroleum-based and now very expensive," explains Longman. "There is an alternative product, extruded polystyrene, which is 30 cents per square foot cheaper than polyiso. You can reduce the cost of building and not sacrifice the insulation value of the roof."

Speaking of roofs, here is another hint from Longman. If you can find a way to remove some of the rock, or weight, from a roofing membrane systems, that translates down to the load carrying capacity of the structural steel. With a lighter roof, the total tonnage of steel needed to support the roof is reduced.

Perhaps the most unusual suggestion for saving on material costs is to eschew most construction materials and go with an air structure.

Air-supported structures, which one usually sees over a sports facility such as a tennis court or soccer field, are now being used for industrial type buildings because they are semi-permanent with a lifespan of 10 to 30 years, says **Ron E. Scharf, Corporate Associate** and Chairman of Arizon Companies, an SIOR Corporate Associate firm in St. Louis, Missouri. "On a temporary or permanent basis they are great solutions to industrial applications like warehouses, distribution centers, bulk storage facilities, and general-purpose manufacturing facilities."

And, they are relatively inexpensive to build. "If an office building costs $300 to $500 a square foot to build and a tilt-up distribution center costs $100 to $125 a square foot to build, the air-supported structure would cost $10 to $15 a square foot," says Scharf.

Looking at Land

If you are not locked into an already acquired property, then a new location could be a cheaper alternative. One part of the construction puzzle is actually going down in price—raw land.

Another take on that comes from Galesi Group's DiNapoli, who says his company looks for properties in empowerment or enterprise zones, where there are tax incentives and tax credits. "We try to find opportunistic situations because in our area rental rates have not kept up with the times," he says.

Competitive Labor Costs

Finally, labor and subbed services are also parts of the construction equation that are softening. A few years ago, there was so much work available that even the day laborer could pick and choose projects. Not today. With the residential and commercial markets both extremely soft and little building ahead, everyone from architects to general contractors to some suppliers are reducing prices to stay competitive.

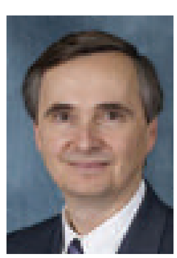
"In this market, negotiate with contractors," says Geenty. "Identify the subs you want to work with and see if they will take a discount. You can negotiate anything. Someone asked me recently about design and I said you can spend $10,000 to $12,000 on a master plan for a 25- to 30-acre plot. I said I would call some contractors and ask if they had any suggestions. One came up with the name of a very fine firm, which recently did a similar job for $2,700. The answer is shop like crazy."

Longman says his company did a project in June, which had scheduled $450,000 of asphalt pavement. "A couple of concrete contractors submitted a voluntary alternative cost," he adds. "There was only a five percent premium as compared to asphalt, which was unheard of. It used to be a 30 percent premium. While the total pavement with concrete did not cost less, the long-term viability of the pavement grew by 10 years. Asphalt lasts 20 years, concrete 30 years."

Look at All Options

Probably, the most basic and time-tested way to moderate the cost burden of construction materials is good planning.

"Whether it is a renovation or new construction, you have to



get it all planned out in advance. Rush decisions and change of orders get very expensive," says **Frank H. Hird, SIOR,** a building and office specialist with O,R&L Commercial in Branford, Connecticut. "You want to get on board with a good team. Everyone has to be involved in the process. And don't pull the trigger until everybody is ready."