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Surging Construction Costs: Implications for Commercial Real Estate

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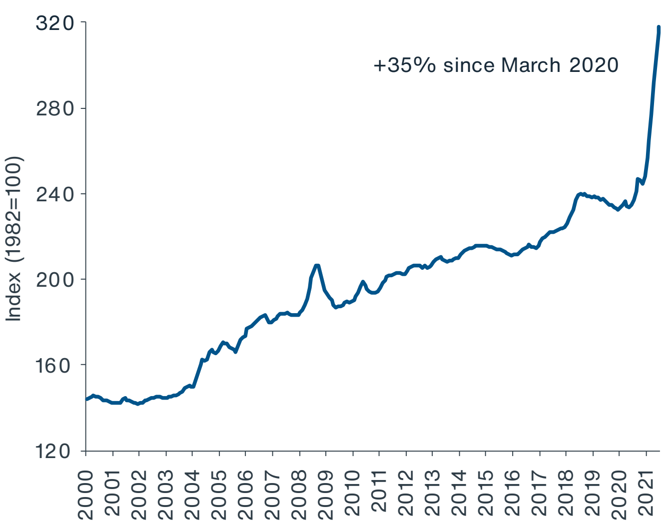
INTRODUCTION

In the year that followed the onset of the global COVID-19 pandemic, there was an unprecedented surge in construction costs. Nationwide, building materials rose at the fastest pace in a decade from March 2020 to September 2021 *(Figure 1)*. Many key construction material prices climbed rapidly, in particular, lumber, metals, and plastic products *(Figure 2)*.[1] Subsequently, commercial real estate (CRE) development and renovation costs rose significantly, and many planned projects have experienced sizable budget increases and substantial delays.

According to a recent survey by the National Multifamily Housing Council (NMHC), 93% of the largest U.S. multifamily construction companies have experienced steep material price increases and a lack of available construction supplies.[2] In recent months, some commodity prices had slightly improved; however, overall building costs remained elevated, up by approximately 35% from early 2020.[3] The sharp increase in construction costs is having profound impacts on both new development projects and existing CRE assets.

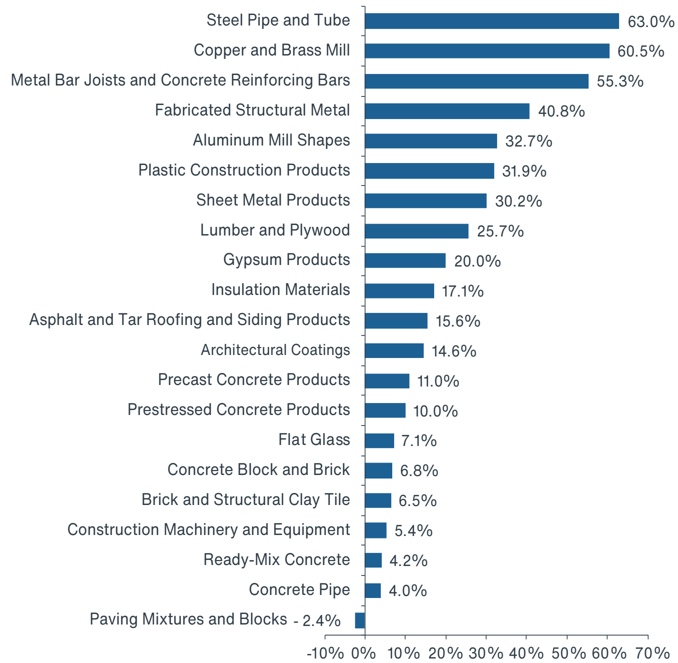
FIGURE 1: PRODUCER PRICE INDEX (PPI) FOR CONSTRUCTION MATERIALS (2000-2021)



Source: U.S. Bureau of Labor Statistics, Clarion Partners Investment Research, September 2021.

Alexandria, Virginia

FIGURE 2: CONSTRUCTION MATERIALS PRICE MOVEMENT (MARCH 2020-AUGUST 2021)



Source: U.S. Bureau of Labor Statistics, Clarion Partners Investment Research, September 2021.[4]

CAUSES OF COST INCREASES

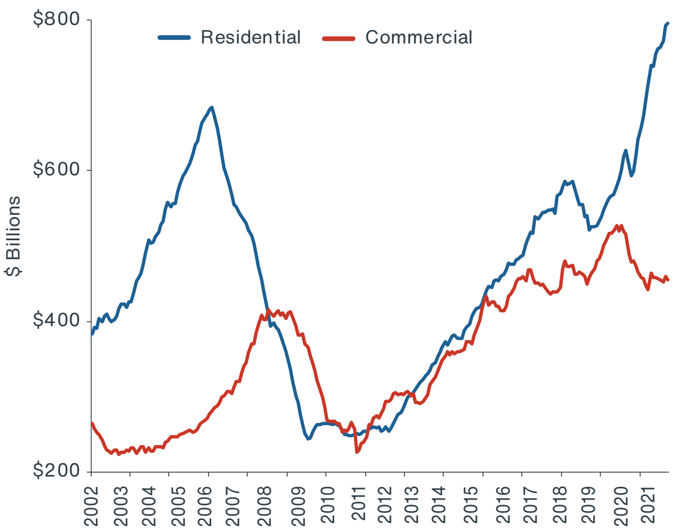
The rapid run-up in construction prices may be attributed to several factors that were caused or exacerbated by the pandemic:

- **Pandemic-Induced Supply Chain Disruptions.** The onset of the global COVID-19 pandemic precipitated a rapid and unexpected demand shock in 2020. Suppliers scaled back production dramatically because of COVID-related concerns and in response to weaker demand. Across international markets, there were severe disruptions in labor, production, and transportation, which led to widespread inventory shortages into 2021 as demand rebounded sharply. More recently, there has been a surge in shipping demand, causing widespread and prolonged delays at major U.S. ports. Global supply chain bottlenecks are exacerbating shortages of components and leading to surging prices of critical raw materials, squeezing manufacturers and retailers around the world.[5]
- **Synchronized Global Recovery.** After a short-lived yet steep recession in 1H 2020 that interrupted normal business conditions, a synchronized global economic recovery, or demand comeback, is now underway. In Q3 2021, U.S. total retail sales climbed to the highest level on record. A faster-than-expected domestic recovery has resulted in acute imbalances between demand and supply due to the gradual revamping of production capacity and rehiring of skilled workers.

- **For-Sale Housing & Home Improvement Boom.** Partially driven by the pandemic and people's desires for less density and more living space, new and existing U.S. home sales reached a 15-year high in 2020 and have since remained near that level every quarter.[6] At the same time, for-sale housing inventory has stayed near all-time lows through Q3 2021.[7] Nationwide, housing starts have also been running at the highest levels since the mid-2000s.[8] Furthermore, private residential investment, measured by spending on building materials and home furnishings, soared by over 20% from Q4 2019 to Q2 2021, as many Americans invested more in home renovations and expansions during lockdowns and increased remote work.[9]
- **Commodity Market Speculation.** As the prices for construction materials surged, some suppliers and developers stocked up inventories to hedge further price increases, which may have exacerbated the demand and supply imbalance. Furthermore, some commodity investors bought futures contracts to try to profit from the price run-ups.
- **Higher Construction Wages & Labor Shortages.** Over the past decade, U.S. labor costs have continued to climb and accelerated significantly in the last year. Construction wages have picked up in the past year, up by 5.8% year-over-year in September 2021 (well-above the 10-year average of 2.2%).[10] In recent years, the CRE industry in general has experienced a labor shortage, in particular of skilled labor, which intensified during the pandemic. The U.S. construction unemployment rate dipped to 4.6% in August.[11]

Over the past two years, residential construction spending has skyrocketed while commercial construction spending, including most "non-residential" property, declined *(Figure 3)*. This comes as most commercial sectors, such as office, retail, and hotels, have reported more muted absorption levels, while those of industrial, multifamily, and life sciences have remained robust. At the same time, demand for all forms of residential for-sale housing has remained very strong, as there continues to be a shortage of high-quality and affordable housing in many parts of the country, as more and more live in a broader mix of living arrangements and locations amidst favorable demographic tailwinds.

FIGURE 3: RESIDENTIAL & COMMERCIAL CONSTRUCTION SPENDING, 2002-2021[12]



Source: U.S. Census Bureau, Clarion Partners Investment Research, August 2021.

IMPACT ON THE CRE INDUSTRY

Overall, higher construction prices have mainly impacted the overall CRE industry in four ways, which may continue in the near future.

- Tighter margins on new development and renovations;
- Project budget overruns and delays; according to a recent survey by the International Data Corporation (IDC), 78% CRE owners were over budget on construction projects and were an average of 70 days late on projects;[13]
- More moderate development pipelines, largely excluding multifamily and industrial; and,
- More room for rent growth and appreciation at existing properties due to higher replacement costs.

However, the anticipated effect on Clarion Partners' target overweight sectors varies considerably based on current supply and demand dynamics.

Industrial: With vacancy near all-time lows and absorption at record highs, industrial demand has remained extraordinarily robust over recent years and throughout the pandemic.

Residential: With the recent strengthening of home property values, single-family home builders also have a greater ability to pass on the increasing financial burden to buyers through higher purchase prices. On the other hand, stick-built low-rise and garden-style multifamily have been more impacted by the recent spike in lumber prices, while high-rise multifamily was less affected, as lumber is less of a key building material for this format. While the recent decline of lumber prices is welcoming new development, overall construction costs for multifamily remain elevated.

PROPOSED INFRASTRUCTURE SPENDING

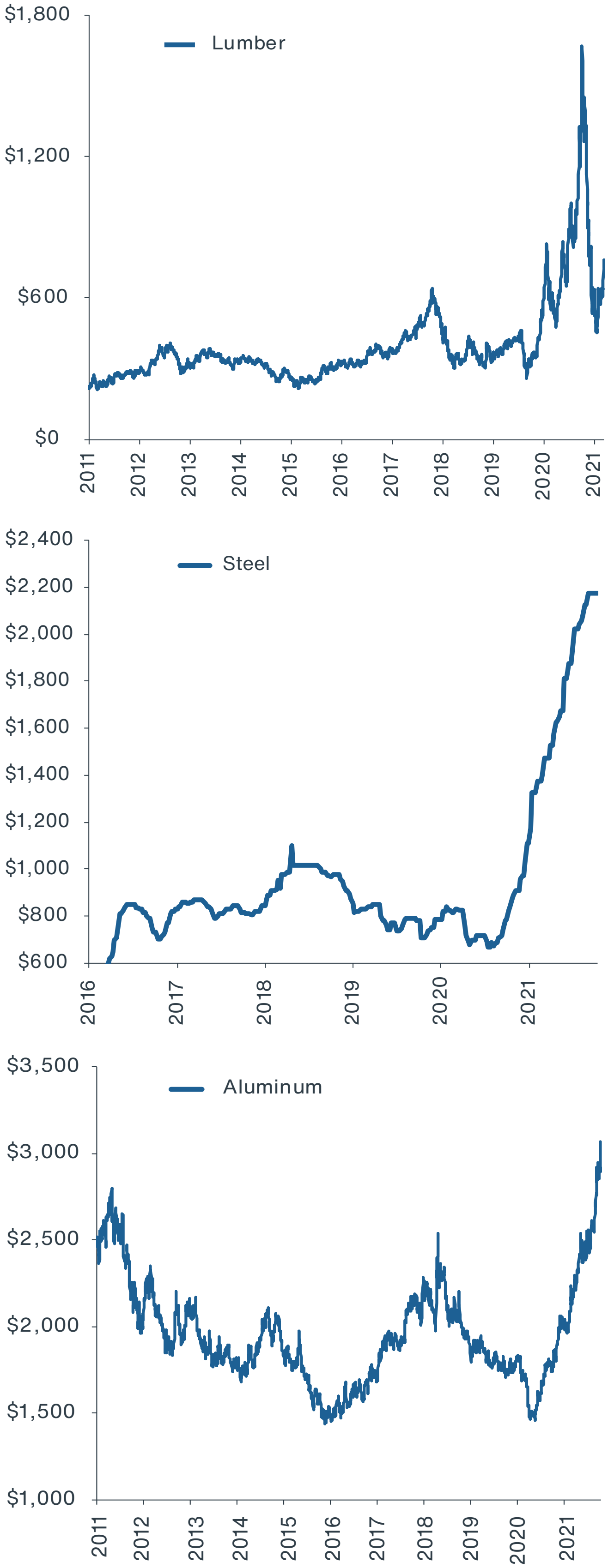
In the years ahead, there may not be a signifcant correction in the recent run-up in construction prices if supply chain disruptions remain and the infrastructure spending legislation is approved. The Biden administration's massive infrastructure plan is likely to have a major impact on construction costs over the outlined five- to eight-year spending period, impacting both material and labor costs nationwide. The planned $1.2 trillion "Bipartisan Infrastructure Framework" is expected to make large-scale investments in clean air, water, and transit infrastructure.[14] The program will direct billions of dollars towards major clean energy and transportation initiatives, universal broadband infrastructure, cleanup of legacy pollution, and environmental remediation programs.

Other considerations or potential risks that may impact the construction supply/demand outlook include: new COVID variants, tariff/trade policy, the pace of Chinese economic growth, and new construction technologies that may achieve greater economies of scale in production.

OUTLOOK: CONSTRUCTION COST PRESSURES LIKELY TO STABILIZE BUT STILL REMAIN ELEVATED

Looking forward, construction costs may moderate as production and supply chain disruptions ease. Historically, commodity prices have been volatile with large swings. For example, lumber spot prices rose almost threefold to a record of $1,670 per thousand board feet in May 2021; however, prices have plummeted in recent months to below $600 per thousand board feet as sawmills ramped up production and some suppliers began to sell their lumber inventory *(Figure 4)*. Nonetheless, as of Q3 2021, pricing for many key construction materials remained elevated, as global production and supply levels had not universally improved.[15] For example, prices remain well above prior peaks for steel and aluminum.

FIGURE 4: LUMBER, STEEL, & ALUMINUM SPOT PRICE



Source: Nasdaq, Clarion Partners Investment Research, October 2021. Note: Spot price data on a daily frequency through 10/13/2021 and steel is based on cold rolled coil steel. Units are: lumber = $/BFT ($ per board foot), aluminum = $ per ounce, and steel = $ per ton.

CONCLUSION

The unprecedented surge in construction costs is having a significant impact on both new and existing CRE. Higher commodity prices, supply chain disruptions, a shortage of desirable development sites, and a tight labor market can make development and renovation projects more expensive and cause substantial delays. On the positive side, owners of existing properties should have a greater ability to maintain and increase rents amidst rising replacement costs and a manageable supply pipeline, which may further boost asset appreciation going forward.

Nonetheless, there is likely to be ongoing and tremendous demand for institutional-quality or "Class A" space, while there is still widespread functional obsolescence across the CRE investable universe, which will justify new development. Given higher building costs in the near-term, Clarion Partners recommends targeting property sectors with the highest demand (e.g. rental housing, logistics property, and life sciences facilities) and markets/submarkets with the most acute supply constraints, where landlords have the leverage to grow rents.

Alexandria, Virginia

[1] U.S. Bureau of Labor Statistics, Clarion Partners Investment Research. Q3 2021. Note: Data displayed is not seasonally adjusted producer price index.
[2] NMHC. September 2021.
[3] U.S. Bureau of Labor Statistics. October 2021. Note: Based on Producer Price Index by Commodity: Construction (Partial): New Nonresidential Building Construction, Index June 2009=100.
[4] Ibid.
[5] *WSJ. Global Supply-Chain Problems Escalate, Threatening Economic Recovery*. October 2021.
[6] Ibid.
[7] Ibid.
[8] Moody's Analytics. October 2021.
[9] U.S. Census Bureau, U.S. Bureau of Economic Analysis. October 2021.
[10] U.S. Bureau of Labor Statistics. October 2021.
[11] Ibid.
[12] U.S. Census Bureau, Clarion Partners Investment Research. October 2021. Note: 1) Nonresidential construction (labeled as commercial in chart) spending covers construction work done each month on new structures or improvements to existing structures for private sectors. 2) All nonresidential building types included in the data, but not limited to are offices, hotels, retail, warehouses, health care, infrastructure, education, recreational, and manufacturing. 3) Residential construction spending is construction work done each month on new structures or improvements to existing structures including, but not limited to single-family homes or apartments buildings.
[13] BusinessWire. *78% of Corporate and Public Real Estate Owners Over Budget on Construction Projects: IDC Survey*. August 2021.
[14] www.whitehouse.gov. June 2021.
[15] U.S. Bureau of Labor Statistics, Clarion Partners Investment Research. October 2021.