USAA Real Estate

Construction materials shortages: Implications for industrial real estate

The pandemic has accelerated tenant requirements for modern industrial and logistics real estate. In response to this extraordinary demand, construction activity has proliferated. At the same time, the pandemic has exposed significant challenges for supply chains globally, disrupting the flow of raw materials and finished goods. Research shows that ongoing disruption is driving a global shortage of raw building materials, resulting in increased input prices and extended lead times. There are growing concerns that materials shortages could put the brakes on construction activity, leading to real rent growth and a scarcity of supply in 2022. This article addresses these themes, and finds that:

- Overall, prices of construction materials are rising; however, headline data understates the severity of cost inflation, with some individual materials rising much more sharply.
- Longer delivery times can be traced back to disruptions in global transportation — notably, a shortage of shipping capacity.
- Increased materials pricing and required lead times are causing some property developments to be paused or delayed. Assuming demand remains robust, we could see historically low vacancy rates in 2022, as new supply will simply not be available.
- With continued strong demand and increased materials costs, industrial and logistics rents will likely continue to move up to align with the increased cost of development. This bodes well for the fundamentals of existing properties, as well; increasing replacement costs may be a "rising tide lifting all boats" in the near term.
- Elevated pricing and delays are possible throughout 2021 and potentially further into 2022, based on demand forecasts.

Construction activity

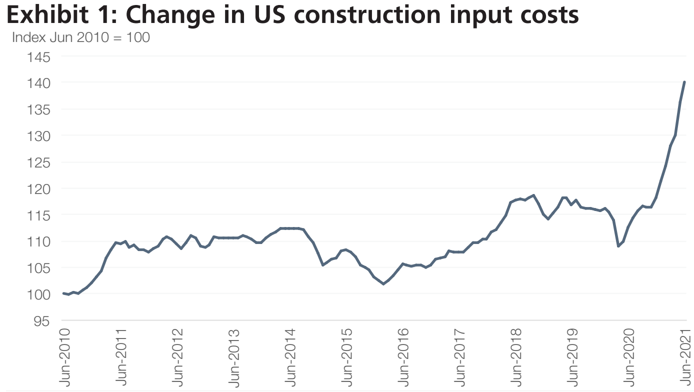
The construction industry has proven surprisingly resilient in the face of multiple lockdowns, public health restrictions and temporary supply-chain breakdowns. Construction within certain segments has been notably robust. As a result of the pandemic and the rising demand for goods bought online, the industrial and logistics sector is booming. Markets in the United States and Europe have posted robust in-process development activity. However, challenges are emerging, which suggests it may be challenging in the near to medium term to sustain construction at these levels. Disruption to the labor supply, increased materials prices and longer lead times could lead to development cost increases and project delays in the industrial sector.

Rising materials costs

Currently there is a global shortage of raw building materials, as the pandemic disrupts supply chains and the construction sector enjoys a boom. The shutdown last spring of raw materials processing plants, followed by a robust global recovery in construction, made it difficult to rebuild depleted stocks of materials. Substantial global monetary and fiscal stimulus measures have also increased demand.

During the past year alone, input costs for nonresidential construction in the United States have soared 25 percent (see Exhibit 1).[1] Anecdotal evidence indicates many of the materials used on typical industrial projects are experiencing sharp daily price increases and procurement delays. Some of the largest increases are for roofing materials, structural concrete, and steel. Materials availability issues are hitting lead times with delays of 12 months or more for some products. This compares with lead times of four to six weeks, prior to the pandemic.[2] While this trend is likely to persist in the short term, it is important to note that this inflation may be transitory.

Exhibit 1: Change in US construction input costs



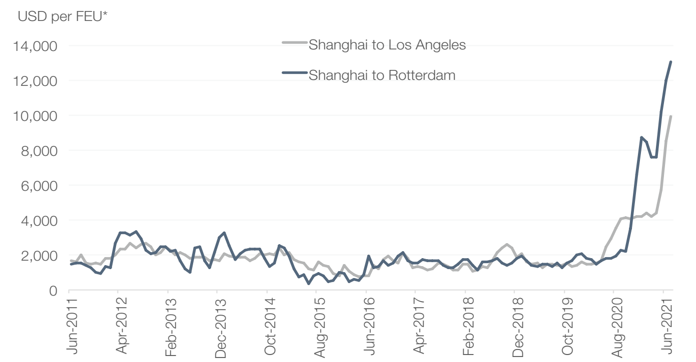
Sources: US Bureau of Labour Statistics, USAA Real Estate Research
PPI Inputs to nonresidential construction, goods, not-seasonally adjusted

Europe is further behind the United States in terms of economic recovery, due to the slower vaccine rollout and lower levels of fiscal stimulus. Demand has not exacerbated supply shortages to the same extent or led to such widespread price increases. Nevertheless, the overall cost of materials for new nonresidential construction in the United Kingdom has risen 7.6 percent from March 2020 to March 2021. Some individual materials have risen much more sharply. Fabricated structural steel prices have risen by 18 percent in the past 12 months, while concrete reinforcing bars have escalated by 20 percent.[3]

Extended lead times

The shortfall of production and the resulting emergence of accumulated backlogs of work could be traced in many instances to supply-chain delays. Longer delivery times were most commonly linked to a shortage of global transportation, notably shipping, in many cases attributed to a lack of available containers and to port congestion. Limited space on ships to send goods has led to a record increase in global shipping costs and delayed freight deliveries. As shown in Exhibit 2, the price for a container of goods from China to the US West Coast and European ports has hovered near record highs for several months. The higher shipping costs have been triggered by multiple factors, including soaring demand amid record levels of stimulus, limited availability of freight containers, and inundated ports with insufficient labor supply. The impacts are clear — higher prices and extended lead times.

Exhibit 2: Global shipping costs



*Sources: World Container Index/Drewry, USAA Real Estate (*FEU is 40-foot equivalent unit container)*

Industrial and logistics market fundamentals

Insatiable demand for industrial and logistics space is driving construction activity across markets. However, there are growing concerns that materials price escalations and shortages could hamper construction activity, leading to a significant spike in rent growth due to limited supply. Notably, US industrial construction completions have slowed in each of the past two quarters, with the second quarter of 2021 registering the lowest amount of new supply added to the sector in over three years.[4] Companies on both sides of the Atlantic are leasing industrial and logistics space at a historically robust pace to satisfy the significant increase in demand.

In the United States, this has resulted in record-high net asking rents for industrial and logistics properties. Assuming demand remains robust, we could see historically low vacancy rates in 2022, as new supply will simply not be available. Materials shortages are already resulting in development cost increases and project delays in the US industrial sector. Material shortages mean that development projects may take more than a year to be delivered due to the extended lead times being quoted. This compares with a typical project timeline of between eight and 10 months. With continued strong demand and increased materials costs, tenant competition for limited new supply will likely fuel further growth in rental rates. This bodes well for the fundamentals of existing US industrial properties, as well, as replacement costs rise. With a shortage of new supply, there will be less space available for prospective tenants, but there will also likely be fewer new projects available for investors. With a significant amount of capital targeting the industrial sector, this could well lead to further cap-rate compression.

Europe has typically seen lower rent growth in the past economic cycle, as compared with the United States, but here, too, market fundamentals have begun to shift the dynamics. Tenant competition for modern, well-located logistics facilities and increased land costs have brought new record highs for rents in several markets across Europe. With continued strong tenant demand and increased construction costs, logistics rents will likely move up to align with the increased costs of development. Land values are not expected to decline as a result of recent construction-cost escalations; however, the disruption could result in land-value increases leveling out. In the meantime, liquidity and investment appetite are increasing, so higher construction costs may be partly offset by continued cap-rate compression. The key difference in Europe is there is a greater degree of confidence that this inflationary pressure will be transitory. This is largely due to the existing slack in the labor market and lower level of government stimulus, as compared with the United States.[6]

Conclusions

The strength of occupier demand for industrial and logistics space during the pandemic has continued to fuel new development. Competition for modern, well-located facilities combined with increased construction costs suggest rents will continue to accelerate. The good news is that rising prices should encourage additional production. As the pandemic disruption fades, suppliers will be in a better position to respond to demand, so this may alleviate some of the pressure on materials. This will help to moderate increases, although, in the short term, additional price escalation and longer lead times are expected. The speed with which cost pressures fade will be contingent on how quickly logistics disruptions are resolved and capacity is rebuilt to help resolve supply-and-demand imbalances.

Notes:[1] US Bureau of Labour Statistics, July 2021; [2] USAA Real Estate Research, June 2021; [3] Office for National Statistics, March 2021; [4] CBRE, US Industrial Availability Index, July 2021; [5] Capital Economics Briefing, May 2021

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CORPORATE OVERVIEW

USAA Real Estate provides co-investment, acquisition, build-to-suit and development services for corporate and institutional investors, and arranges commercial mortgage loans on behalf of affiliates. The Amsterdam-based operation is actively engaged in developing, acquiring and managing institutional-quality real estate investments, primarily through its pan-European logistics venture, Mountpark Logistics EU.

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