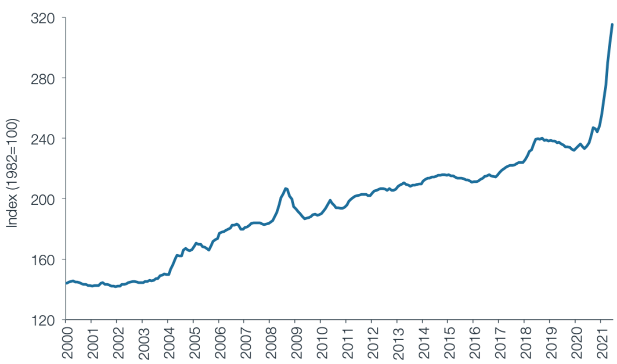
Clarion Partners

Surging construction costs: Implications for commercial real estate

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 the first half of 2020 to the first half of 2021 (see Figure 1). Many key commodity prices climbed rapidly, in particular lumber, metals and concrete products.[1] Subsequently, commercial real estate (CRE) development and renovation costs rose significantly, and many planned projects have experienced sizable budget increases or have been delayed. As of July 2021, some construction material prices had slightly improved; however, overall costs remained elevated, up by approximately 30 percent from early 2020.[2] The steep 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)



Sources: U.S. Bureau of Labor Statistics, Clarion Partners Investment Research, July 2021

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. More recently, there has been a surge in shipping demand, causing widespread delays at major U.S. ports.

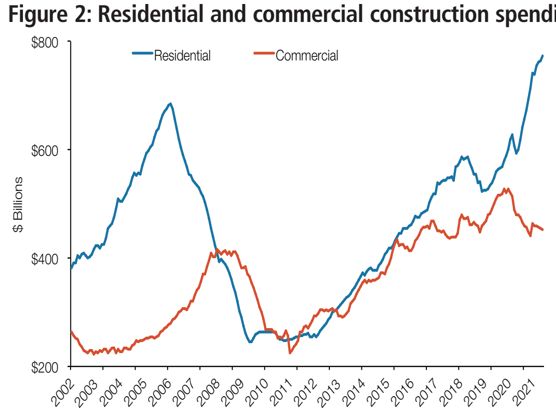
Synchronized global recovery. After a short-lived, yet steep, recession in the first half of 2020, which interrupted normal business conditions, a synchronized global economic recovery, or demand comeback, is now under way. In the second quarter of 2021, U.S. total retail sales reached the highest level on record and rose at the highest annual pace ever. 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 and home-improvement boom. New and existing U.S. home sales reached a 15-year high in 2020 and have since remained near that level every quarter.[3] At the same time, for-sale housing inventory has stayed near all-time lows through the first half of 2021.[4] Nationwide, housing starts also reached the highest level since 2006 from fourth quarter 2020 through second quarter 2021.[5] Furthermore, private residential investment, measured by spending on building materials and home furnishings, soared by over 20 percent year-over-year each quarter from fourth quarter 2019 to second quarter 2021, as so many Americans invested more in home renovations and expansions during lockdowns and increased remote work.[6]

Higher construction wages and labor shortages. During the past decade, U.S. labor costs have continued to climb and accelerated significantly in the past year. Construction wages, in particular, have picked up year-over-year, up by 3.7 percent in July (well above the 10-year average of 2.2 percent).[7] In recent years, the CRE industry, in general, has experienced a labor shortage, in particular of skilled labor, which intensified during the pandemic.

During the past two years, residential construction spending has skyrocketed, while commercial construction spending, including most nonresidential property, declined (see Figure 2). At the same time, most commercial sectors, such as office, retail and hotels, have reported more muted absorption levels, while industrial, multifamily and life sciences trends have remained robust. On the other hand, 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 people live in a broader mix of living arrangements and locations amid favorable demographic tailwinds.

Figure 2: Residential and commercial construction spending, 2002–2021[8]



Sources: U.S. Census Bureau, Clarion Partners Investment Research, June 2021. Note: Data series for residential spending starts in 2002.

Impact on CRE industry

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

– Tighter margins on new development

– Project budget overruns and delays. According to a recent survey by the International Data Corp. (IDC), 78 percent of CRE owners were over budget on construction projects and were an average of 70 days late on projects.[9]
– More moderate development pipelines, largely excluding multifamily and industrial
– 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 high in recent years and throughout the pandemic. Therefore, developers have the confidence to pass on higher costs of new development to future tenants through higher rents. Nonetheless, higher land costs and land availability, especially in infill locations, may hinder some new industrial development projects.

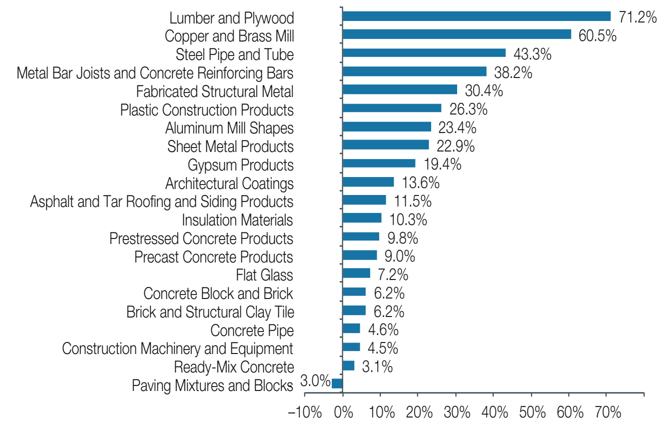
Residential. With the recent strengthening of home property values, single-family home builders also have a greater ability to pass on the increasing financial burden to buyers through higher purchase prices. Stick-built low-rise and garden-style multifamily developments are likely to be more impacted by the recent and any future run-up in lumber prices, while high-rise multifamily may be less affected, as lumber is less of a key building material for this format.

Outlook: Construction cost pressures likely to stabilize but remain elevated amid significant infrastructure plan spending

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 the most significantly over the past year, almost threefold to a record of $1,670 per thousand board feet; they have plummeted in recent months, however, to below $500 per thousand board feet, as sawmills' ramped up production and more suppliers began to sell their lumber inventory.[10] Nonetheless, as of the first half of 2021, pricing for many key construction materials remained elevated, as global production and supply levels had not universally improved (see Figure 3).

At the same time, there is likely to be growing competition from other large-scale infrastructure spending initiatives, which may exacerbate ongoing material and labor shortages. 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 transformational and historic investments in clean air, water and transit infrastructure.[11] 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.

Figure 3: Construction materials price movement (March 2020–July 2021)



Sources: Bureau of Labor Statistics, Clarion Partners Investment Research, second quarter 2021. Note: Data is from producer price index and is not seasonally adjusted.

Conclusion

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

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 barriers to entry and supply constraints.

Notes: [1]U.S. Bureau of Labor Statistics, Clarion Partners Investment Research, second quarter 2021; [2]U.S. Bureau of Labor Statistics, July 2021; [3]Ibid.; [4]Ibid.; [5]Moody's Analytics. July 2021; [6]U.S. Census Bureau, U.S. Bureau of Economic Analysis. July 2021; [7]Moody's Analytics. July 2021; [8]U.S. Census Bureau, Clarion Partners Investment Research, May 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, healthcare, infrastructure, education, recreation 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 apartment buildings.; [9]BusinessWire, "78 percent of Corporate and Public Real Estate Owners Over Budget on Construction Projects: IDC Survey," August 2021; [10]Bloomberg, July 2021; [11]www.whitehouse.gov, June 2021

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CORPORATE OVERVIEW

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