



With headwinds abound, will Trump's metal tariffs send NYC developers over the edge? by Paul McCormick and Amit Israni

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NYC real estate developers feel like they are in a boxing ring right now, and with good reason. They are being jabbed by more expensive financing, while receiving a left hook and body shot from stricter lending standards and loftier land costs. Will President Trump's plan to impose tariffs on aluminum and steel imports deliver them a knock-out punch?

Probably not as the beauty of NYC to investors will likely remain boundless. Interest in well-priced, high-quality locations should remain robust amid a limited supply of available land. While consistent rezonings and tax incentives also favor the market, developers right now face more challenges than in the recent past.

As economic conditions continue to improve, the Federal Reserve is expected to tighten monetary policy further in 2018, ultimately leading to even higher interest rates. The Fed is confident that the economy is robust enough to withstand the impact of rising rates, which was evident when its policy-making arm in March raised benchmark short-term interest rates by a quarter-percentage point to a range of 1.5% to 1.75%.

While developers have resigned themselves to rising borrowing costs, they may not have anticipated its current pace, with the central bank raising rates at a 25 basis point clip every three-to-four months over the past year. The Fed has penciled in two more rate hikes in 2018, matching 2017's three increases, but a stark acceleration from just once each in 2015 and 2016.

Long-term Treasury yields, which influence everything from mortgage rates to corporate loans, pierced 3% for the first time in four years in April due to a combination of strong corporate earnings and rising energy costs. A rise in oil prices fanned concerns about inflation, which diminishes the value of fixed payments made on long-dated bonds. The 10-year yield had mostly been on a downward trajectory since its prior four-year high in February. Geopolitical tensions with North Korea, Syria, and Russia, as well as worries about a trade war with China, the world's second-largest economy, fueled demand for safe-haven assets.

It has become more expensive to finance construction projects. The WSJ prime rate index, used by many banks to price construction loans, reached 4.75% in March, 0.75% higher than the same month last year. That means a borrower seeking a \$10 million loan right now must pay \$75,000 more annually for financing than a year ago. Interest rates from traditional lenders for construction loans are now about 5.75%-6.25%.

More stringent lending is also sapping the bottom line of builders as they are being forced to raise more equity. Around this time two years ago, the loan-to-cost ratio was around 70% for a mortgage, higher than today's average of 55%. Developers must get more creative, going to the private sector where they can get more proceeds, but where the cost of capital is 300 basis points higher.

When the real estate development market took off from 2012 to 2015, it was truly a perfect storm since "hard" and "soft" costs were attractive. Financing was relatively inexpensive, the amount of leverage a borrower could take was higher, and land was markedly cheaper. On top of that, labor/union costs and outlays for material were far below where they are today.

According to data compiled by Ariel Property Advisors' Investment Research Division, a 70,000 buildable s/f mixed-use development project completed three years ago in NYC would yield a 20.5% leveraged return versus 11.5% this year. This data assumes that only interest rates, hard and soft costs, and equity injection increased as all other factors held constant.

Despite this, a belief that gains in the rental/condo markets could offset or even outpace these obstacles could keep developers optimistic and motivated to buy land at its current pricing.

Developers are increasingly concerned about profitability due to President Trump's proposal to impose a 25% tax on steel and 10% tax on aluminum imported from certain countries. The White House has set a June 1st deadline for the European Union and other trade allies to come up with concessions to address the U.S. trade deficit, or face tariffs on these metals. If enacted, these metal tariffs should drive up the cost of development in the city, which is already sky-high.

The price of steel has been on the rise for several years, but since Trump's initial announcement in March, the steel price per metric ton has jumped over 10%. In December 2016, the price was \$670, according to SteelBenchmarker's HRB Price, an industry pricing tool. As of April 9th, the price stood at \$941. Developers use steel for a plethora of purposes, most noticeably for structures of buildings.

With demand for steel likely to outpace domestic supply, these tariffs may incur added costs by either delaying the timeline or outright halting projects. This added expense, however, may not be too much of an impediment for developers. That's because more than 50% of the steel imported to the U.S. comes from Canada and Mexico, which are both excluded from the tariffs. A rise in costs could cause developers to press the pause button when it comes to green lighting future projects, ultimately constraining construction at a time when solid economic growth typically bolsters activity.

NYC saw a 3.29% increase in average construction costs from January 2017 to January 2018, according to an analysis conducted by The Real Deal. Substantial development projects are already in the pipeline that require a colossal amount of steel. This includes Tishman Speyer's 2.85 million s/f office tower at Hudson Yards

Perhaps the most weighing variable in the development market right now is exorbitant land costs. In Manhattan, the average price per buildable s/f in 2017 was \$746, a climb of 14% from 2014's \$654, according to Ariel's research. The expense of a site in Northern Manhattan leaped 22% to \$217 from \$178 during the same period.

Even with all of the above, the future looks quite bright for the development market. While interest rates have risen, they remain historically low, and a fresh crop of new alternative lenders, both individual and institutional, have swiftly emerged with a fresh appetite to extend credit. So, while soft and hard costs have gone up, institutional and private developers will likely continue to break ground in NYC, the world's top destination for real estate investment.

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