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Letter of Intent - Construction Costs

December 09, 2013 - Front Section

One aspect of the current cycle of recovery in the commercial real estate market is the continual increase in the cost of construction, a facet of the process that most do not think of when deliberating their next project in the midst of the development boom. The costs of materials and labor have increased as demand has risen for not only skilled labor, but also the upper echelon of builders to work on the most coveted projects. The inflation in cost of materials is greatly due to the upsurge in residential building, in addition to the major metros increasing the number of multifamily properties according to RLB, which provides a construction cost index. The index is comprised based on the cost of materials at the wholesale level, and what contractors and sub-contractors charge for those materials. This year, there was a 3.6% overall increase in the cost of construction compared to the previous year's increase of 1.5%, most of which was given a year end boost in 2012.

The tremendous national upswing in single-family housing development is putting the pressure on the prices of housing construction-related materials, which in turn, is also pushing wages further north. The construction industry has only recovered approximately 15% of the jobs lost during the recession and therefore, skilled labor is at a high demand. Labor shortages will continue to remain elevated and probably continue to drive up costs.

There are varying levels of inflation nationally that lead to differing degrees in the increases in overall costs. New York, of course, is at the top of the list. Although as previously noted, the national average was a 3.6% overall increase, New York boasts a 6.9% increase, making it the most expensive city the nation to build in. Some analysts attribute this to the immense projects taken on in the Tri-State area in the wake of Hurricane Sandy, which required unprecedented amounts of materials, increasing the already inflated costs for these materials, as well as the necessity to pay laborers overtime in order to maximize efficiency and complete the projects in an expedited manner.

A recent study conducted by Thompson Research Group shows that distributors tend not to increase prices too dramatically until the manufacturing capacity utilization is above 80%. The current output is just below 82%, which means that either we will witness another increase in the cost of materials (spurred by the residential market for items such as lumber, gypsum, etc.), or contractors, in order to stay competitive in cities such as New York, will have to eat the loss in profit margin.

Remember though, that while the increase in costs of lumber and steel would be very detrimental to the bottom line, (one study shows that a 5% increase in the cost of steel would equate to an average of a 2.5% loss in profits in NYC), interest rates are still low and seem to have hit a plateau. Berko & Associates capital markets group recently provided construction financing with 85% leverage, making the increases and the potential drawbacks of a more expensive construction proposition a little easier to swallow.

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