DISSECTING REPLACEMENT COSTS

Important Factors in Comparing Market Averages

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In normal market conditions, replacement costs can feel like a moving target. So it is no surprise that the volatility of the past three years – including a global pandemic, the shutdown of the Chinese economy, persistent supply chain disruptions, a war on European soil, a deluge of economic stimulus, the ensuing sharp rise in inflation – has made it increasingly difficult for investors to find footing.

From property owners and investors to insurance companies and mortgage servicers, the commercial real estate industry has been heavily impacted by economic and geopolitical upheaval. As widely discussed, the current value of certain buildings has dropped below the cost to rebuild or replace with like materials, increasing risk and opportunity across the board. To help guide decision making, a proprietary Transwestern model estimates hard and soft replacement costs across 12 U.S. markets, for directional uses only.

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CONSTRUCTION LABOR REMAINS A TOP CONCERN

Construction firms are falling far short of the number of needed workers. Overtime is a short-term solution, which could ultimately intensify labor shortages/costs of labor by boosting burnout levels. Since 2020, thousands of experienced workers have moved to residential construction, found jobs in other sectors, or left the workforce completely. By November 2022, construction employment was 126,000 more than in February 2020, but a large shift was noted between residential and nonresidential sub-sectors. Compared to February 2020 levels, residential construction added 210,000 workers, while nonresidential construction was still down 86,000 employees, or 1.8%.

Evidence indicates that the construction industry would have added more workers had they been available. The Bureau of Labor Statistics (BLS) reported construction job openings totaled 377,000 in October 2022, exceeding the 314,000 construction workers hired in the same month, implying demand doubled availability. This gap in labor created nominal pay growth, which did not keep up with what was required to attract, retain or lure workers back to the overall construction industry, and in particular, commercial construction. Over the coming year, construction labor costs are expected to increase 10% -15% in an effort to close the labor gap, which will have a continued impact on replacement costs overall.

VOLATILITY IN COST OF MATERIALS PLAYS ON

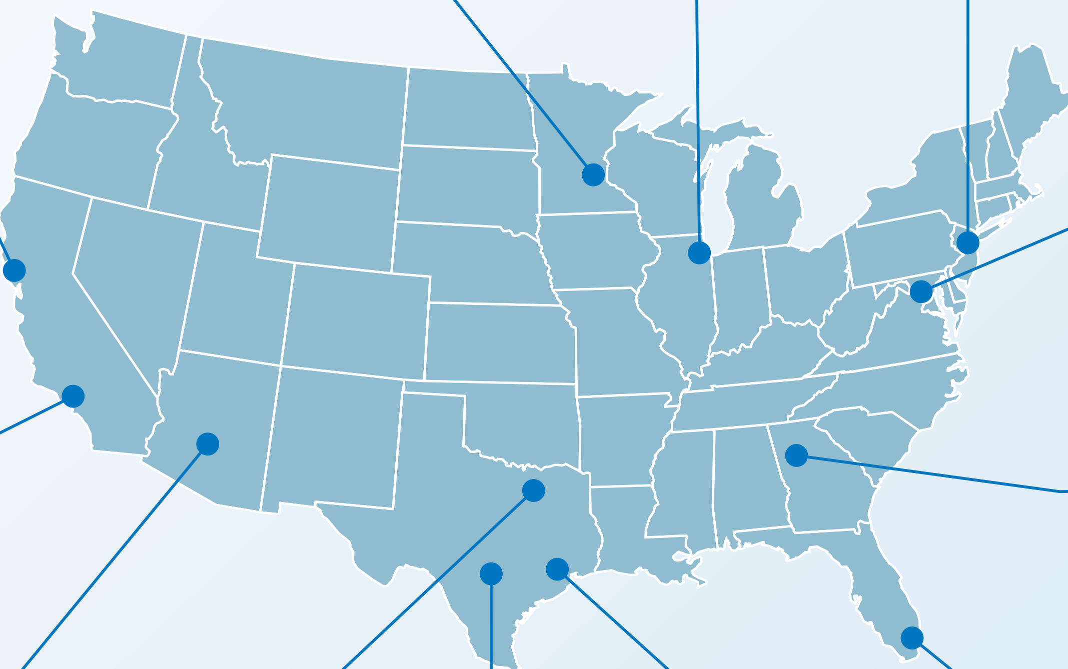
Several factors are contributing to the continued volatility of construction materials, a situation that is likely to persist even after the economy finds its landing point. Wildfires, hurricanes, flooding, a war that has spurred trade restrictions, and supply issues that have not recovered from the 2020 global economic shutdown coalesced to wreak havoc on what had come to be considered “normal” – and this was further exacerbated by increased demand and a tight labor market.

From 2022 to 2021, construction costs rose 17.5% YoY, and cost of materials averaged 23% more in 2021 than 2019. Within those numbers, specific commodities saw huge price increases; lumber, for example, jumped 117% in one year before receding. If and when all variables return to pre-pandemic “norms,” there will still be a delayed market reaction, and this response lag will persistently impact replacement costs.

AVERAGE U.S. REPLACEMENT COSTS*

ASSET CLASS

- Standard Office
- High Rise Office
- Multifamily - Garden
- Multifamily - Wrap
- Industrial - Big Box
- Retail - Power Center
- Retail - Strip



Asset Class	Minneapolis	Chicago	New York	San Francisco	Los Angeles	Washington	Atlanta	Phoenix	Dallas	San Antonio	Houston	Miami
Standard Office	$492	$549	$608	$597	$514	$439	$410	$400	$395	$385	$398	$391
High Rise Office	$615	$687	$760	$746	$643	$549	$513	$500	$494	$481	$498	$489
Multifamily - Garden	$437	$488	$539	$530	$456	$390	$364	$355	$351	$342	$353	$347
Multifamily - Wrap	$510	$570	$631	$619	$533	$456	$425	$415	$410	$399	$413	$406
Industrial - Big Box	$160	$179	$198	$194	$167	$143	$133	$130	$129	$125	$129	$127
Retail - Power Center	$271	$302	$334	$328	$283	$241	$226	$220	$217	$212	$219	$215
Retail - Strip	$240	$268	$296	$291	$251	$214	$200	$195	$193	$188	$194	$191

*For directional purposes only

Source: Transwestern Research Services

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DELAYS AND INDECISION ABOUND

Examples of developers and owners delaying major office, industrial, and multifamily projects are widespread. Remote work is keeping office vacancy rates stubbornly high, interest rates continue to rise, and the weakening economic climate have slowed development across all asset classes. In tandem, lenders are tightening their underwriting, focusing on the debt coverage that they have – whether properties' cash flows can support debt with a higher interest rate – and they're finding that they are not so sure what the exit is when the property is ultimately sold.

Borrowers are also worried about the repayment of debt. Lenders are practicing restraint and the equity is also being appropriately cautious. This has been a catalyst in the slowdown but may prove beneficial in coming quarters by controlling overbuilding and creating an environment more favorable to a softer landing for commercial real estate.

WHEN TO PROCEED OR PAUSE

The cost of construction material and labor do not move in unison with the overall economy, as we have witnessed. For that reason, there is inherent risk to the overall budget in delaying projects. Furthermore, it is unlikely delaying a project will avoid volatility; more likely, it will change which variables deliver the volatility.

For example, rising construction costs at the beginning of the pandemic were not always passed along. Uneven demand across project types and fear-based reactions resulted in firms not adding price increases into bids to win contracts. On occasion, contractors assumed prices would fall prior to making the actual material purchase. Then, as construction demand accelerated through 2021, inflation became an established issue, ultimately causing contractors to raise prices to an even greater extent and continuing a chain reaction. Bid price increases did not "catch up" with the increase in input costs until summer of 2022.

Timing decisions, therefore, must be carefully weighed considering the trends within each property sector as well as the specifics of each individual asset.

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