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How the High Cost of Development Produces Market Distortions

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By Steve Bergsman

For SIOR specialists in the industrial and flex product markets, the real estate downturn has produced a number of economic distortions that are, in effect, local market conundrums.

Quickly moving trend lines in the national and regional economies, capital sectors, and ultimately in the property markets have created unusual twists that must be unwound before developers and brokers can start building and leasing in quantity again.

Expense to Build Rental Property Doesn't Allow for Fair Return

Take, for example, the situation **Richard C. Stanland Jr., CCIM, SIOR,** NAI Avant, in Columbia,

South Carolina, faces. Stanland, the 2000 President of SIOR and an office specialist in Columbia, reports the industrial market boasts a low vacancy of 2.4 percent, but no new space is being built with the exception of a couple of 150,000 square footers.

There is also older, Class C space that is not getting backfilled. Part of the problem is that new, Class A space leases for about $5.00 per square foot, triple-net with the larger boxes leasing for $4.50 to $4.75 per square foot. The "bread and butter" deals in the Columbia market are typically 25,000 to 50,000 per square foot build-to-suits where construction costs are now approaching $45 per square foot and should command a $6.00 per square foot rental rate to yield a decent return. We are simply not a $6.00 per square foot market. As Stanland laments, "we have a robust market, but the dichotomy is that even with 2.4 percent vacancy, the demand is not strong enough to force rents through the $6.00 per square foot barrier."

It would be easy to say the problem can be attributed to the increased cost of construction material, but that is not necessarily the case in Columbia, says Stanland. "We have regulatory authorities passing new laws and regulations in regard to landscaping, curbing, and everything else and that just drives up development costs even further. Those costs are not even related to construction materials."

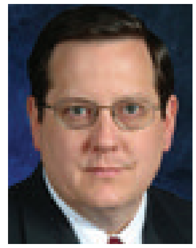
Prospective tenants are running head on into the barrier of rising construction costs versus the market's ability to raise rents. Given a choice, these prospects will then head to Atlanta, Charlotte, or in some cases Greenville and Charleston where space is more plentiful and rates are more competitive.

"The cost of new buildings in our area is a problem," notes **David C. Murray, CCIM, SIOR,** Vice President of R.B. Murray Co. in Springfield, Missouri. "There is an inventory of existing buildings that have a competitive advantage. It is impossible to charge enough rent for new product to make a decent yield or what has been historically a fair return."

Oddly, this has not stopped development. "What has happened locally," Murray says, "is some of our developers have continued to build product because they already have an inventory and they are equity builders. I have one customer who has more than a million square feet of inventory and continues to build the portfolio, keeping the number of developed square feet the same as the last three years."

Although yields are down, Murray's customer will accept less return instead of a historic 10 to 12 percent, because they are in the market for the long term.

Developers in a Quandary—Can't Afford to Build, Can't Afford Not To



"The development business is driven by fees and you can only earn fees by building," explains **H. Allen Gump, SIOR,** an Executive Vice President of the industrial division of Colliers International in Dallas, Texas. "If you have commitments and financing, you do not want to let go of that. If builders have the land, they do not make any money on it unless they have a building. In fairness, developers know that if they have the land and it is entitled, they cannot compete with other projects down the street if they do not have a building up."

A bigger problem, especially in the Dallas area, says Gump, "is that we are seeing a lot of tenants wanting to limit the terms of their leases to two to three years instead of signing for seven to 10 years. There is a fair amount of reticence in the market to ink long-term deals."

That, of course, flies in the face of tenant build-outs, which are higher-priced now than they have ever been. "We have shells being built, but it's hard to get them leased because of the tenant finish costs," says Gump. "Finishing out office space on a shell building is almost becoming cost prohibitive for short-term transactions. These deals are becoming economically unviable because you cannot get rents and terms."

"I am working with a local company right now that wants to move and is considering two buildings," says Gump. "The first is a shell building that was never finished out. The second one was previously built out for another tenant and would require a significant retrofit. The company wants a three-year lease, but the landlords need at least five years in order to amortize the cost of what is, in this case, a heavily finished office build-out. You can't get there from here. There's a 99 percent chance the company will just renew the lease where they are."

Construction Costs Up, Cap Rates Up, Rents Flat

Industrial does not play out any better in larger cities. Chicago, with almost 1.4 billion square feet of industrial space, ranks as the country's biggest industrial real estate market. "The city has been predominantly a speculative (spec) investor market

because of the relatively deep pockets that investors have here," explains **Scott Pfisterer,** Executive Vice President of Elgin, Illinois-based Capital Realty & Development LLC, an SIOR Corporate Associate member firm.

But, spec building is in trouble. "Although construction costs are up 18 percent over the past 12 months, the real problem is the lending community," says Pfisterer. "It was not uncommon to be able to get 75 to 80 percent loan-to-value, but these days it is just 70 to 75 percent. And cap rates are up. On top of that, rents are flat. So in Chicago, construction costs are up, cap rates are up, and rents are flat. All that leads to different development markets."

In the second quarter of 2008, Chicago spec industrial building completions were down about 33 percent as compared to the first quarter, and the vacancy rate rose 9.38 percent, reported Colliers Bennett & Kahnweiler, a Rosemont, Illinois, commercial real estate brokerage firm.

Pricing volatility in the Chicago market has been extreme, says Pfisterer. "The general contracting community in Chicago has been able to hold to prices for no more than two weeks, which makes the whole pricing mechanism, forming the pro forma, and valuing the project, more challenging."

For some Chicago builders, the only solution has been to turn to smaller buildings.

Financing Becomes the Hurtle

In the Ontario Inland Empire market that serves the Port of Long Beach/Los Angeles, the higher cost of construction has been offset by the disappearance of capital for new developments. With the local residential market in collapse, contractors' labor costs have moderated, however material costs continue to increase.

Still, not much is getting built because of the capital markets. "Financing is by far the biggest hurdle," observes **Walt Arrington, SIOR,** a Senior Vice President with CB Richard Ellis in Ontario. "You cannot get anything built because financing is frozen."

Few lenders are going to cough up dollars for new development given the condition of the U.S. financial systems and as Arrington notes, "to make matters worse, sluggish demand and overbuilding have created a 20 percent vacancy in the Eastern Inland Empire submarket."

If it is any consolation, Arrington says, a lot of land will be coming back on the market and sporting better numbers. Although local developers certainly covet the real estate, it is almost impossible to buy at any price without financing.

The constricted capital markets are having an impact on industrial and office markets in a number of unusual ways. Traditionally, landlords have scrutinized the financial condition of potential tenants, but in California, some tenants are investigating the financial conditions of potential landlords.

Financing TIs

"How ironic that the tenants that we represent are

now checking out the landlord's financial condition instead of the other way around says **John Robbins, MRICS, SIOR,** a Principal in San Ramon, California-based tenant representation firm Carpenter/Robbins Commercial Real Estate.

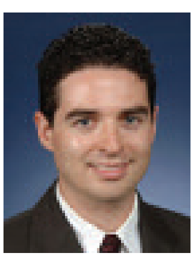
"We are encountering situations where the landlords cannot even get the money for TIs they promised, which means the tenant has to go somewhere else, expect reduced improvements, or put in their own money," Robbins adds. "Nobody in any corporation or government agency wants to be surprised by that kind of capital need."

Recently, Robbins' company represented a federal government client that was looking for a fairly small amount of space and settled on taking 10 percent of a local building. "The landlord committed to the lease and then went back to his bank," says Robbins. "Even though it was just a small portion of a larger building, the bank would not lend him the money for the TIs. We had to go look for new space."

Generally speaking, says Robbins, "We are finding landlords are not making enough allowances for skyrocketing TI costs and tenants are unaware of the cost of tenant improvements. Tenants are especially shocked at the differential between "market rates" and the cost of a build-to-suits. One of the things we have done is tighten up our estimates so we can get a better idea of what those costs will be upfront. We have developed a program for predicting future rents for build-to-suits. Simply put, replacement costs are way ahead of in place buildings in our market, and the cost of financing has put proforma rents way ahead of current market rents."

But, in our markets, the lack of new development comes down to one simple factor, no demand.

Residential Affecting Commercial Needs



"Our market has been especially hard hit," notes **Christopher J. Masino, Candidate,** with Grubb & Ellis|WestMar in Temecula, California, near Riverside. Part of the problem in places like Temecula is that the impediment lies outside the dynamics of industrial space needs; it is all about the collapse of the residential market. "We have had a lot of residential property foreclosures and a sustained downturn in residential eventually effects the commercial real estate market," says Masino. "I recently read that the unemployment rate in Riverside County was nearly nine percent. This percentage is higher than the national average because Riverside County has lost many jobs in both construction and those industries providing services and products for the residential real estate market."

On the demand side for industrial and office space, Masino continues, "commercial property investors and users are generally making the decision to simply wait until after the current economic downturn subsides. Most people are feeling less wealthy; this mentality has resulted in lower demand, higher vacancy rates, and discounted lease and sale rates for commercial real estate products in our sub-market."

In what might also sum up a few national markets, Masino says, commercial real estate investors in his region, "are keeping their head down and waiting the storm out." That is an investment paradox that few brokers can overcome.