RESEARCH BRIEF

CONSTRUCTION

APRIL 2023

Elevated Interest Rates are Expected to Curb CRE Development in 2024

Construction starts hindered. A tight labor market, strong wage growth, and elevated costs for food, services and housing have all contributed to keeping overall inflation elevated. The Fed has responded to this by hiking interest rates. As of late March, the overnight lending rate was at 4.75 percent, the highest level since December 2007. Also, despite a retreat in shipping costs and the average prices of steel and gasoline in recent quarters, construction materials costs remain elevated on a historical basis. Both higher interest rates and steeper building costs are having an impact on the commercial real estate construction sector.

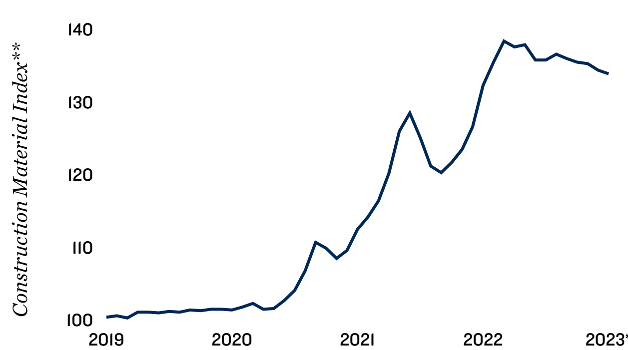
Costs for building remain elevated. While projects that have already broken ground or locked in financing are still moving forward, many external factors are limiting new development starts. Banks have been executing fewer construction loans relative to previous years, as lenders tighten underwriting in response to increased risk exposure. If developers are able to secure loans, they come at rates well-above measures recorded prior to the health crisis. Furthermore, material costs for developers are still 33.5 percent above pre-pandemic levels, and wage growth in the construction sector registered 5.8 percent in 2022, outpacing the private sector average. While the effect on new supply will be minimal in the near-term, higher costs for financing, building materials and labor are expected to slow future development.

Industrial sector affected. Supply chain disruptions and a change in consumer spending habits elevated the need for industrial space, driving a significant rise in new product. Supply additions will reach a two-decade high in 2023; however, a slowdown in development is expected. Construction starts already declined by roughly 40 percent in the fourth quarter of 2022 relative to the previous three-month span. Also, Amazon, which accounted for roughly 16 percent of all warehouse starts over the past three years, recently announced plans to halt new construction. Fewer groundbreakings this year will translate to fewer deliveries down the line.

Retail and office construction to slow. While the total amount of square footage set to be delivered for both office and retail properties is projected to increase year-over-year in 2023, new proposals in these sectors are showing signs of deceleration, and construction starts this year for both property types are expected to decline. Demand for brick and mortar retail has changed amid the increased prevalence of online and omnichannel shopping, while work-from-home trends have spurred a decline in office usage rates. The limited competition from new supply should aid performance metrics at existing retail and office properties.

Developers bullish on multifamily. Although elevated interest rates and recent bank failures, along with increased material and labor costs, are curbing new development starts for many property types, the apartment sector continues to see record inventory growth. Completions in 2023 are expected to reach the 400,000 unit mark for the first time in over 30 years. Furthermore, multifamily project starts during February of this year reached the second-highest monthly measure in three decades, indicating momentum is not slowing for new construction in the sector. An ongoing national housing shortage and steep barriers to homeownership are elevating developers' confidence, and will likely continue to drive the development of new communities in the near- to mid-term.

Costs for Building Materials Still Above 2019 Level



** Through January; ** Index: January 2019=100*
Sources: Marcus & Millichap Research Services; U.S. Census Bureau; U.S. Bureau of Labor Statistics; Coresight Research