BlueRockPartners
Commercial Real Estate Advisors

NEWSLETTER

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Prices Paid for Lofty Construction Costs

It isn't unusual for Hawaii to rank among the costliest metro areas in the country and for many shopping center owners and retailers this is one of the primary learning curves in considering an entrée into our state. Over the decades we have had ebbs & flows but we never venture far from the top.

We currently find ourselves in the throes of a full blown expansion cycle and the escalations in construction costs have been on a staggering run over the past 18 months. In what is nearly a One Trillion dollar industry annually, it would seem that large percentage fluctuations would be unlikely. Unlikely; but not impossible.

According to Rider Levett Bucknall's construction cost report, the first 9 months of 2014 had an increase of 1.7% nationally. By the time the fourth quarter of 2014 had elapsed, the national increase for the year was at nearly 5.5% - an increase of 3.8% (or about $350 billion dollars) in just one quarter.

The only thing outpacing Hawaii's development scene are the prices of construction

Directing this subject back to Hawaii, our state topped the list of metro areas with the largest jump at more than 13% year over year. But that is a trailing set of figures. What is not reflected in those numbers, but is a reality for us, is the current state of constructions costs as we approach the midpoint of 2015. Bear in mind that with expanding market conditions, construction costs are bid on a going forward basis which generally results with higher estimates and more generous budget contingencies.

In the past 90 days we have had numerous clients, colleagues and vendors reporting construction bid increases of 25%-30% over just the past 9 months. Besides some of the obvious elements, there are various theories about what has accelerated these numbers, but that is for another discussion.

Both owner and occupier are victim to this meteoric trajectory and the collateral damage that results. Multiple projects across the state have been halted or withdrawn entirely. Development groups have had to revisit fundamental conversations about their capital structures due to blown budgets. National retailers have had to redesign their tenant improvement buildouts to bring new unit construction costs down to within real estate committee approved capital allocations. Notably, and as a result of unacceptable construction costs, Walgreens announced it was not going to perform on its lease in the Hokulei project on Kauai.

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Collaboration and across the negotiating table has never been more crucial

An intellectual premium is being placed on deal maker creativity and innovative designers as owners, developers and occupiers find a way to make and preserve commercial transactions. An anomalous and unintended consequence of these conditions is that we are seeing much more collaboration between parties at the negotiating table. Occupiers helping owners problem solve on deliverable & space turnover strategies and owners coaching occupiers who may have limited experience and everything in between.

For the time being the notion that once you have an LOI agreed to or even a lease contract fully executed, that the transaction is a "given" is not a safe assumption. This is not born out of malicious intent as much as a result of construction costs moving faster than the market can amply adjust. Never has the adage "Time Kills Deals" ever rung more true. There is a growing recognition that the best transactional outcomes are going to require a collective effort between both sides of the table.

Being naïve to that dynamic is to invite undue risk into the transaction and the associated costs of retracing covered ground or starting over entirely because historical assumptions were made. The current market conditions leave little room for any assumptions and worthwhile dividends like basic contract performance and reliable cash flow are the rewards to those who are savvy and collaborate across the negotiating table.

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