Booming Budgets

Think competition for residents is fierce? Try bidding for contractors, and even new appliances.

BY PAUL R. BERGERON III

The cost of labor and building materials has been rising right along with rents as the apartment industry and its developers work to complete a flurry of new development, while others take a hammer and nail to their reposition upgrade projects.

Bozzuto's Mike Schlegel, whose company continues to thrive in one of the busiest new construction markets, Washington, D.C., says the most significant consequence he's seeing as President of its construction company is that many projects currently in the pipeline are now struggling to meet underwritten budgets, especially if those budgets were created more than six months ago.

Apartment completions approached record levels last year, as developers delivered approximately 10,000 units in the region. Schlegel expects builders to surpass this number in 2014 and deliver upward of 18,000 units.

"This dramatic increase in activity is only magnified by the current capacity issues our industry is facing," Schlegel says. "A number of our subcontractors are reporting that they are at or in excess of their capacity through early 2016 because of this increase in activity. As a result, our subcontractors and the skilled labor force now have the ability to be selective when choosing projects. They tend to favor large scale, repetitive work projects, because these result in the most efficient allocation of their resources."

The Commerce Department recently reported that construction of multifamily housing hit an annual pace of 423,000 units in July—its highest level since January 2006.

AvalonBay Chief Executive Tim Naughton said in published reports that a combination of demographics, living preferences and purchase behavior is all favoring rental housing today. Naughton cautioned that there could be some headwinds on the horizon.

"In terms of economics, construction costs are now outpacing rent growth since the trough, which starting to squeeze yields a bit," Naughton said.

Essex Property Trust CEO Michael Schall said in published reports that his company may trim its apartment development pipeline from roughly 10 percent of the company's enterprise value to around 5 percent, partly because construction costs may be rising faster than income from apartment communities.

"We're going to be more conservative at this point in the cycle," Schall says.

Schlegel adds that material prices remain relatively stable, but labor costs are rising.

"Within the past year, we have seen a 25 percent increase in bid-day numbers from our wood-frame subcontractors alone, while

lumber prices have barely moved. There just are not enough framers in the market to do the work coming through the pipeline. And we have seen a dramatic increase in the financial stress on our subcontractors."

Schlegel says this means that smaller, complicated projects with work-flow or access issues are at greater risk for inflation than are larger projects with few constraints.

He offers this advice on working projects:

- Ensure that the developer is receiving favorable pricing from subcontractors and suppliers.
- Expand subcontractor and supplier relationships, both to minimize risk and to keep the level of competition high.
- Implement an early pay program with subcontractors who have favorable credit. This can lead to the most favorable pricing available from these subcontractors.
- Promote joint purchasing of subcontractors over multiple projects.
- Increase the capacity of the developer's pre-construction group, which allows them additional time during the design phase of the project to explore all value engineering possibilities while working out constructability issues. This early process with the pre-construction team allows for better drawings that are ready to bid/build, which reduces ambiguity and related costs.

Are Appliances Scarce

Several unique and timely factors have affected the pricing of construction materials and items such as appliances during the current cycle, says Zachary Maggart, Senior Vice President of Construction Services, Bell Partners.

"Materials prices are driven primarily by supply and demand," Maggart says. "However, a developer can also be affected by requesting exclusive specifications where a particular, branded material is wanted for installation where that brand is the only name in town."

Maggart projects a 3 percent to 5 percent increase generally on an annualized basis for material costs. Schlegel also sees some inflation in costs until the middle of 2015, and then he is hopeful that costs will flatten at that point.

As for demand, Maggart says prices won't fall until demand lessens.

"Fewer rehabs in the market might do it, but that's unlikely to happen any time soon," he says.

"As an industry, we are rehabbing the units that were planned five years ago, but which were stopped during the 2008-09 economic downturn."

This demand is making appliances' availability scarce. "The pricing is relatively stable for appliances, but we are having a serious shortage, and we are finding that there are none to purchase on a large scale basis until Q4 2014."

Part of the reason for such delays is that the Department of Energy's regulations are impacting refrigerator manufacturing. GE, for example, told appliance distributors that it would make changes to its refrigerator production process in two stages. The first stage was completed in April and the last stage is scheduled for completion by October.

Developers trying to finish projects and open their apartment homes for leasing can face delay challenges when all appliances are not delivered on time.

Bell Partners' Bell Del Ray in Alexandria, Va., opened earlier this year. Bell Partners Chairman and CEO Steven D. Bell said, "We got this done on time and under budget."

National Averages
20-City Index Shows Steady Increases

McGraw-Hill's ENR.com publishes a monthly index of construction and building costs, based on a national, 20-city average.

Asphalt. Data through August, the most recent that was available, showed that asphalt paving PG-58 oil prices rose 1 percent for the month, following July's 2.5 percent increase, lifting the ENR's average price 2.9 percent above a year ago.

Cement. ENR's 20-city average price for portland cement also rose 1 percent in August and is 4.6 percent above a year ago.

Plywood. Prices bounced back 1.1 percent in August, according to ENR's 20-city average price for 5/8-in. panel. The monthly jump checked four months of declines, but prices are still 1.2 percent below a year ago.

The Bureau of Labor Statistics' producer price index for plywood rose 1.4 percent in May, followed by another 0.7 percent in June.

Rhode Island Row, Washington, D.C., built and managed by Bozzuto.

Labor. ENR.com tracks labor costs in building (BCI) and construction (CCI). The CCI uses 200 hours of common labor, multiplied by the 20-city average rate for wages and fringe benefits. The BCI uses 68.38 hours of skilled labor, multiplied by the 20-city wage-fringe average for three trades-bricklayers, carpenters and structural ironworkers.

The hourly wage for construction labor was $39.94 in August, up .1 percent compared to July and up 3.7 percent year over year.

The hourly wage for building labor (which accounts only for bricklayers, carpenters and structural ironworkers) was flat in August at $51.67 and up 2.8 percent year over year.

—ENR.com's 20-City Index

"As we renovate, we replace the appliance package (including refrigerator, stove, dishwasher and microwave," Maggart says, "In the event one piece is missing or unavailable, we cannot finish the rehab and 'sell' the units as complete."

Maggart says developers can "comparison shop" on price by developing alliance relationships with supply houses and then bouncing the prices off each other for material availability guarantees. "A negotiated price is only good if the supplier can actually deliver the goods," he says.

One San Antonio owner took an out-of-the-box approach to gain a significant discount. Marc Ross, Bob Ross Realty, says non-traditional suppliers can pay off.

"We bid out the purchase of 55 sets of appliances for rehab jobs and one supplier's price was significantly lower than any other," says Ross, who owns or manages 600 units. "We had to take it. And, the [local] supplier [from a national chain] was willing to store the units in his warehouse at no charge and is not charging for delivery. They will deliver them when we need them, which will be one by one over the next six to 12 months, starting in November, as we work through our renovations."

The Frigidaire set includes a refrigerator, stove, dishwasher, microwave and vent. Ross says even though he has to pay 4 percent to 5 percent to finance the deal, "it's still a double-bid discount. And with that discount, we were able to buy a slightly higher-quality model from that label."