

# THE CONSTRUCTION OF THE BOTTOM LINE

Rising construction costs are influencing developers and owners across the Southeast.

by David M. Browne

In today's ever changing commercial real estate market, new factors are affecting the way real estate professionals conduct business. With construction prices skyrocketing to unpredicted heights, labor cost following suit and land prices often doubling and tripling in value, this is a new era in our industry.

Now, the pressure of increasing construction costs is affecting every aspect of the commercial construction business. In the past, those involved with the building industry were complacent because the price of materials could be fixed far in advance if the contractors actually needed the materials. However, construction costs have seen double digit price increases in the past two years. Today, prices for some materials are in such constant flux that they are now valid for 30 days or less. So where does that leave the construction industry in this year?

Take concrete for example. Concrete as already in short supply in more than 30 states when four out of five major import areas were disrupted by hurricanes this past year.

Couple this with the global building boom as concrete is going to China, Iraq, India and many other countries across the world.

Diesel fuel also is in high demand. There have been major increases in diesel and the prices have been slow to retreat. Those who work in the construction industry have no choice but to pay the higher prices. General contractors have been hit hard and have no place to turn. Ultimately, they pass the cost on to the developers, which in turn is passed to end user through sales or leases.

Land prices in the Southeast, especially in South Florida, have increased at epic proportions during the past 3 years with no slowdown in sight. The old adage "he who controls the gold wins" is being replaced with "he who controls the land wins."

During the past year, office condominium construction has increased dramatically. Two years ago, building speculative office condos did not make sense, but today it is the hottest trend in the industry. This is one solution to keep up with the ever increasing cost to

build and buy land because sales of new office condos can generate more revenue than leasing the space. In leased transactions, the landlord not only has to pay a commission to the brokers but also has to shell out \$30 to \$50 per square foot for tenant improvements (TIs). In condo construction, the seller or developer generally does not pay a commission because most of the buyers find the properties themselves and the developers save on TI's by selling the condos as is. Office condos are selling anywhere from \$150 to \$400 per square foot and prices are not slowing down.

What does this all mean for the commercial real estate industry and in particular, office leasing? Three possible outcomes are emerging from the rise in construction costs since, ultimately, the end user gets hit with the increases in land, labor, fuel and materials. It is the trickle down effect and the last source to feel the pinch is the tenant.

The first trend is tenants engaging in longer-term leases, anywhere from 7- to 12-year deals. Landlords still are giving tenants a

base improvement allowance but the allowance is only covering 60 percent of the job. Twelve to 18 months ago, a standard tenant improvement allowance covering 90 percent to 95 percent of the job, leaving the tenant a smaller shortfall than today's market. To get as much tenant improvement dollars as possible, while simultaneously trying to alleviate the large shortfall spread, tenants are accepting longer terms to amortize the tenant improvement dollars. Tenants are generally trading rate for term. Most tenants would rather stretch the term out a few years because they feel comfortable with their future growth than pay \$2 more per square foot for a shorter term.

Another direct outcome of rising construction costs is tenants are phasing in growth. In the past, South Florida businesses would commit to 10 to 15 percent of additional space to account for growth during the next 12 to 24 months. In today's market, tenants are being advised to take

the only necessary space since leases typically include creative expansion language applicable to each situation. The concern is making sure that all expansion options are tied back to the original lease including same rate and terms with a prorated tenant improvement allowance. A second concern is with the economy chugging along and the market changing from a tenants' market to a landlords' market, it is easy to anticipate that landlords will be in need of tenants' optional space. When tenants are approached, they can either exercise their option to keep the space or let it go and hope that there is space in the building when they need to expand.

The final trend is that some tenants are finding it's too expensive to move and choose remain in their current location. In this situation, the tenant restructures their current lease, extends the lease terms and hopefully receives enough tenant improvement allowance from their landlord. Tenants may decide to spruce up the

space with new carpet, paint, wall coverings, etc. In the majority of cases, the least expensive option is to stay put and restructure the lease. In the current whirlwind construction market, many companies are not risking the market and are keeping the same address.

Real estate is an ever changing industry. Even with the unbelievable increases in materials, labor, land and fuel, the commercial real estate market is still thriving and is stronger today than it has been in many past years, with singledigit vacancy rates, exploding sales prices and a stronger economy. All this translates into a landlords' market for this year as concessions disappear. Quality tenant representation will be key.

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