

Construction Costs Weigh on New Development

The lack of new supply in the face of demand for modern assets is supporting values.

Commercial real estate learned an important lesson from the GFC: be wary of overbuilding. Now, with vacancies for asset classes other than office real estate near historical lows, the industry faces a different problem: how to deliver in-demand assets at a cost investors will pay for them.

Sector Commentary

- Although the supply chain issues have moderated, construction costs have continued to escalate, led by labor costs fueled by a shortage of trained construction workers. Demand for electrical and other products that support tech-heavy buildouts continues to outpace supply, challenging delivery schedules.
- Declining private sector construction comes at a time when some sectors are facing tight historical fundamentals. Demand remains high, with limited availability of well-located, modern buildings.
- The retail sector has an average vacancy rate of just 4.1 percent, and continues to see steady rent growth. New supply has been limited for more than a decade, with new deliveries in the past year more than 40 percent below the prior 10-year average.
- Despite average property prices falling almost 5 percent year over year, the industrial/logistics sector continued to see positive rent growth.

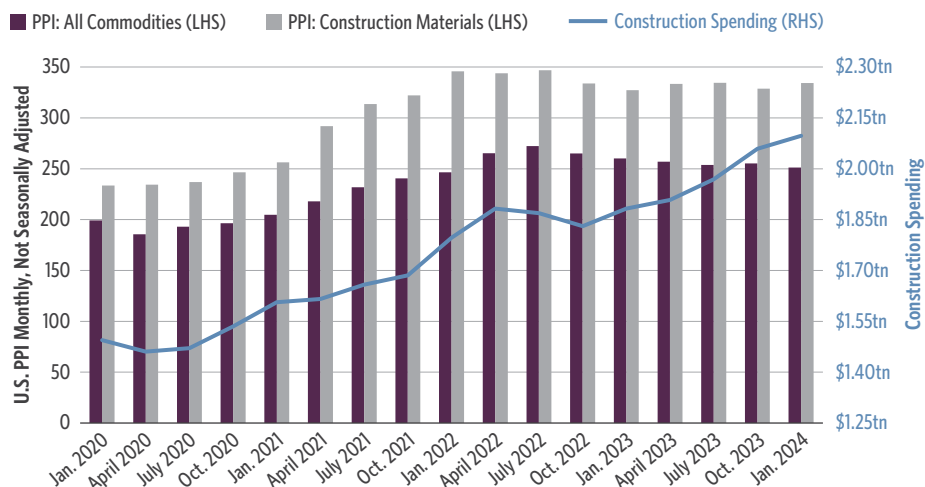
Investment Themes

- The replacement cost to build new properties will serve as a tailwind to the values of existing assets, especially the most modern property types in strong locations that have been constructed in the last five years. With the cost to construct the same product as much as 25 percent higher today, we expect investors will seek opportunities to acquire existing hard assets.
- Companies pursuing on-shoring and re-shoring strategies to alleviate geopolitical risks and supply chain disruptions are also expected to bolster demand for hard assets as they evaluate the cost of constructing new facilities and the potential time delays to source required materials.
- An eventual moderation of interest rates will not be enough by itself to incentivize developers to materially ramp up new construction in the face of such persistent escalation of costs, increasing demand for existing modern commercial real estate.

By Jennifer A. Marler and Farris Hughes

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Construction Costs Continue to Climb Across the Board



Source: Guggenheim Investments, U.S. Census Bureau, U.S. Bureau of Labor Statistics. Data as of 4.30.2024.

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