Commercial Construction Starts, Plans Increase Despite Recession Warning Signs

By Tim Carroll

Interest rates are rising, inflation is at generational highs and a recession may well be on the way, but the cranes on the skyline aren't going away anytime soon.

Construction starts are up and projects in planning rose in May, and experts told Bisnow that isn't likely to change — at least for well-planned projects in sectors of high demand — even if obtaining financing gets harder and the cost of capital continues rising.

"These financing rates are still not, historically, incredibly high, right? And I think that's important," Moody's Analytics Senior Economist Thomas LaSalvia told Bisnow. "While there's a lot of folks in the industry that only entered the industry 10 years ago that have only seen incredibly cheap money or low interest rates, there's a lot of older-timers that saw rates that were considerably higher, and this doesn't scare them as much. They could still make projects work even in this higher-rate environment."

The Federal Reserve on Wednesday raised its benchmark interest rate 75 basis points, its most significant hike since the mid-1990s. But at 1.5% to 1.75%, it is a far cry from the 20% those rates reached in 1980.

Still, a three-decade-high increase could have scared developers away. But despite the Fed signaling its intention to raise rates this month, total construction starts were up 4% in May, with nonresidential starts up 20% compared to the seasonally adjusted annual rate, according to Dodge Construction Network.

Perhaps even more telling of developers' optimism in the face of economic headwinds, the Dodge Momentum Index — designed as a leading indicator of the nonresidential pipeline — showed projects in the planning phase jumped 7% month-over-month in May.

"Very large projects — $5M and above projects, especially those $50M and above projects — don't necessarily run with the business cycle because they take years in planning," Dodge Data & Analytics Director of Forecasting Kim Kennedy said.

Artemio De La Vega, the founder and CEO of Dallas-based retail and mixed-use developer De La Vega Development, said interest rates have to be considered, but if a project has tenant and consumer demand, the right demographics and the right location, developers aren't going to stop development.

On the other hand, those projects that were barely feasible before will become glaringly untenable.

“There's projects that are on the margin that will get axed because they are a little too risky, there's still too many uncertainties going forward, that in a world of higher interest rates and greater scrutiny from financiers and so on, these projects just won't get off the ground if they don't have that cushion," LaSalvia said.

Experts across the development and construction spectrum said demand is a driving factor in their longer-term optimism for the industry, and demand can help create that financial cushion. With a well-documented housing crisis exacerbated by inflation and rents rising with demand, multifamily is in a good position to weather the storm.

“You still have a tremendous shortage of housing. We still haven't caught up from an infrastructure standpoint to supply the demand of the shortage of housing,” said Eurick Dorsett, a project executive at Janey Construction, which works on projects in Boston and Washington, D.C.

But housing demand doesn't make multifamily development bulletproof. Lower returns creep into the picture when developers move away from amenity-rich Class-A offerings and toward workforce and affordable housing.

“At some point, those projects don't pencil out, with the rising financing costs, rising materials costs and presumably a limit to how much they can push up the rents to cover those,” Associated General Contractors of America Chief Economist Ken Simonson said.

Dorsett said a bigger problem than interest rates or any economic headwinds has been the pace of permitting.

“We've got some higher ed and lab projects that we are looking at starting in the latter part of this year, and we’ve basically been sitting on those projects for over a year,” he said. “And they're just slowly going through the permitting process.”

Developers responding to a survey by the National Multifamily Housing Council and the National Association of Home Builders self-reported that regulations, including taking time to comply with ordinances and building codes, eat up more than 40% of development costs.

There is growing pushback against red tape across the country, however. A coalition in Long Island, New York, is lobbying for state legislation that would give municipalities a 45-day window to approve or deny a building permit before the applicant can self-certify plans with licensed architects or engineers. Dallas City Manager T.C. Broadnax is on the hot seat, with those calling for his ouster, including the mayor, citing widespread permitting delays amid the reasons for his potential removal.

Government-sponsored projects are seen as more secure regardless of when they receive permitting.

“The least vulnerable to a sharp rise in interest rates, and certainly to a plunge in the stock market, would be public projects,” Simonson said. “And there we have a lot of tailwinds in the forms of revenue that the state and local governments have already been getting both from their own tax sources and from the federal relief over the last couple of years, as well as prospectively from the investment that will come out of the Infrastructure Investment and Jobs Act."

From a contractor's perspective, the problem isn't finding work — it's finding workers. Simonson said the industry has reached "a persistent state where contractors would like to hire perhaps twice as many people as they're able to find."

In February, Associated Builders and Contractors projected the industry would need to find 650,000 workers on top of the normal hiring pace this year. There were 494,000 construction sector job openings at the end of April, up 47,000 from March and 135,000 from February, according to Bureau of Labor Statistics data.

Simonson said because construction work is performed in the elements and takes a physical toll, the construction industry needs to raise wages even beyond the rates other industries have increased them to entice new laborers to job sites — another cost increase that might affect development.

With transportation project expenses routinely coming in 20% above expected rates because of additional labor costs, according to the AGC, contractors are offering packages that include signing bonuses and housing stipends to recruit new workers, The Wall Street Journal reports.

"It's going to be a challenging time for owners to find contractors and to get those projects up and in use in a timely basis," Simonson said.

Commercial real estate development is famously the domain of the optimist. For those who can stomach the bad times and keep an eye on the horizon, even a potential recession — which more than 60% of CEOs think will happen and JPMorgan Chase strategists peg as an 85% probability — could be seen as an advantage.

De La Vega, who is working on mixed-use developments in the Dallas-Fort Worth Metroplex, said if recession fears were realized later this year or in 2023 and the nation began to recover in 2024, DFW — among the most active cities in the U.S. for construction — would likely be on the leading edge of the recovery around when projects that are in planning now would deliver.

"We would be the beneficiaries of better pricing with contractors, lower interest rates down there for the second half of the project," he said. "We're in the right city with the right product in the right location."