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Skilled Labor Shortages, Rising Costs Threaten Multifamily Deals

Market conditions and rent-restrictive housing policies stand in the way of new starts for many developers.

By Chris Wood

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Kyle Bach never figured on a bat cave being one of the things he'd have to deal with as an apartment and student housing developer. In 2018, the CEO and president of The Annex Group had closed financing on a new development in Bloomington, Ind., when groundbreaking was halted in deference to the Indiana bat, an endangered species extremely sensitive to hibernation disruptions. Once the bats woke up, torrential rains turned the site into a mud pit, and Bach was forced to again wait on construction, wondering all the while if he'd even be able to lock down reliable, affordable crews to work the project. "I'm from Indiana and didn't even know we had a thing called the Indiana bat until it extended our construction time frame by seven months," Bach says.

During the delay, construction costs marched on their inflationary way, and The Annex Group was lucky to get that project (and several other affordable housing and student communities) under development this year. “It’s going to end up being our biggest year ever, but we have critical concerns about construction costs. Tariffs are driving up material prices, and our No. 1 challenge in every single one of our markets is finding qualified labor.”

Construction costs in the U.S. rose 5.7% in 2018, according to the Rider Levett Bucknall North American Quarterly Construction Cost Report, with Chicago (7.6%), Portland, Ore. (7.1%), San Francisco (6.7%), Phoenix (6.7%), and Washington, D.C. (6.5%) experiencing the worst inflation. Escalations in the Canada–U.S. softwood lumber dispute and the U.S.–China trade war have material prices soaring, but developers fear the bigger, more looming challenge lies in finding skilled labor to get units out of the dirt.

“Material costs are one thing, but the labor scarcity is what’s making it a challenge to get more deals done right now,” says Richard Broder, founder and CEO of Broder & Sachse Real Estate, which has developed two multifamily mixed-use luxury properties in Midtown Detroit over the past two years. “There’s simply an absence of laborers, including labor that fled during the recession and labor that is retiring, and it could be an issue that we deal with for a generation. In the short term, what can be done to attract labor to our business when everyone in the country is already working? And what on top of that is going to lure them back to Detroit? Probably nothing.”

Dave Crawford

Mill Creek Residential’s Modera Midtown features 435 luxury apartments spanning 29 floors in Atlanta’s Midtown neighborhood. However, construction costs have prevented Mill Creek from pursuing more starts in the city.

Cost Deterrents

In Atlanta, construction costs have contributed to keeping the regional Mill Creek Residential office from pursuing more starts. While the developer has long relied on internal construction teams to help alleviate the labor issue, macro cost inflation still makes it risky to attempt to overcome other market challenges at the same time. "It's a big reason why we have an in-house construction group, because it gives us more control over the process," says Mill Creek managing director of development Harvey Wadsworth. "But a lot of the land opportunities we see have unrealistic expectations on price or zoning or permitting problems and so they sit, and that's because of development costs. If things were going a little bit better you might be able to overcome some of those other challenges."

Like many other metros, Atlanta also continues to experiment with inclusionary housing policies that often mandate a portion of units be built to certain affordability levels.

In a period of cost-constricted development, however, cities are often unable to increase housing affordability without decreasing market-rate supply, which in turn ironically drives up overall rents.

"It's creating significant challenges and has effectively shut down multifamily development in the city because of those policies," says Wadsworth. "But I believe inclusionary housing is here to stay because I don't know that the policymakers or even the general public understand our business well enough to see how it can break down a deal. A lot of times they just want cheaper housing and want us to pay for it."

Avi Sinai is the founder of HM Capital, a hard money lending firm in Los Angeles, where he estimates construction costs have increased by up to 50% in some significantly challenged submarkets.

The Vanishing Inspector

There's more to fear from the skilled labor shortage than just able bodies on the jobsite. Building inspector and code enforcement offices are experiencing a similar talent drain, creating backlogs for permitting and inspections and making the approval of variances and improvements all the more problematic for apartment builders.

"Everyone wants to talk about the lack of contractors, but there are less qualified people working through the permitting and entitlement process, too," says Harvey Wadsworth, managing director of development in the Atlanta office of Mill Creek Residential. "There's a revolving door at the local municipality level as they lose people to the private sectors, and they are struggling to keep good people as well. It's a huge impact in trying to get things out of the ground."

The International Code Council and National Institute of Building Sciences have been warning of a talent dearth since 2014, when an industrywide survey found that more than 40% of building code officials were older than 45, and 82% of all officials were planning to leave the industry within five to 15 years.

"We are thankfully seeing a rise in the number of general contractors who are older and interested in moving into inspection and away from the hard labor of contract work, but we still have a shortage of qualified inspectors and limited interest by younger people," confirms Danielle Rubio, executive director for the American Construction Inspectors Association.

With a limited number of reviewers and inspectors available, permitting challenges can be exacerbated in hotter markets, and developers should build out timelines accordingly.

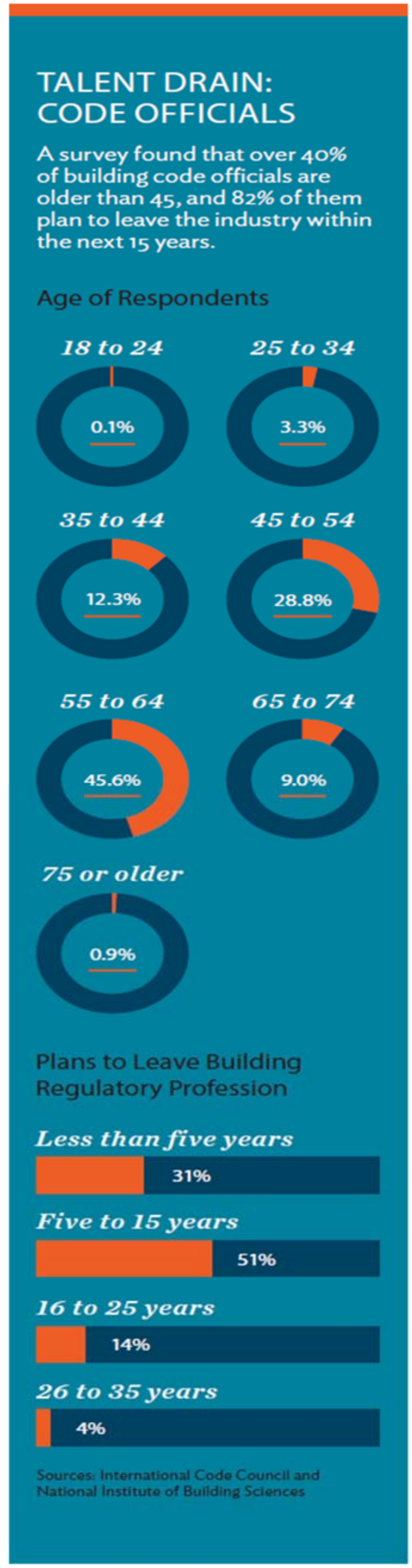
"We've often had three different inspectors over the course of a project, and each one has a different interpretation of the code," says Chris Pilato, vice president of construction and development for Rockville, Md.-based CAPREIT. "We're consequently extended lead times and always trying to be cognizant of large clubhouses and other issues that could trigger fair housing and accessibility issues. Permitting can already take six to eight weeks, and we don't want to be doing construction during peak leasing season."

On top of that, most of the firm's multifamily clients are wary of housing policies being informed or influenced by ballot activists. Sinai points to California Proposition 10, which would have implemented statewide rent control on newly constructed apartments, and a Santa Monica initiative to mandate any new development over two stories be subject to citywide public referendum as examples of such activism gone awry.

"It's crazy, right? But we're beginning to see these intersections between local politics and investments where tenant rights groups are authoring and lobbying the public on these far-reaching bills," Sinai says. "For the past two years, we have seen clients sell off property because they are afraid of regulations and what is coming in the next cycle. In Santa Monica, the measure was defeated, but the core argument motivating it was simply that there was too much traffic, and that sentiment is nationwide and could fuel activism anywhere."

Bach says it's not just market-rate multifamily getting hit by inclusionary zoning. The Annex Group is also seeing university towns including affordability provisions against student housing developments.

As an affordable housing developer, The Annex Group has been nimble enough to navigate its student deals with affordability requirements to completion, but Bach wonders if purpose-built affordable housing per se isn't the better route to go. "Oftentimes, I don't know that the municipalities even understand the mechanics of a deal," he says. "The economics of inclusionary rents simply don't make sense with land costs going up, utilities going up, and the overall margins becoming very thin, and I do think affordable communities versus inclusionary zoning is a better solution to serve the need."



Labor Woes

Regardless of whether inclusionary zoning factors into its upcoming student housing developments (The Annex Group has five that are likely to close in 2019), Bach still struggles mostly with the labor issue and has even moved to import his own crews to some of the firm's secondary, emerging markets. "We tend to focus on tier 2 or tier 3 schools, and oftentimes there are a few larger subcontractors that will travel with us regardless of location," Bach says. "Although that may not immediately solve for costs, at the end of the day we have intimate experience with those subs in what we build and want to provide, and that has mitigated the risk of labor scarcity."

It could be that the smaller markets with smaller labor pools are hardest hit from a worker availability and cost standpoint. At Rockville, Md.–based CAPREIT, the purchasing team has been able to negotiate material price increases from 10% to 15% down to a 5% average for the year by purchasing in bulk, but finding contractors outside of the major D.C. and Baltimore submarkets can still be a deal breaker.

“The labor issue is just a whole other ballgame, with cost increases up to 25%,” says Chris Pilato, CAPREIT vice president of construction and development. “The smaller projects are where you really get hit. We have two deals in St. Mary’s, Md., right now and there just are not a lot of contractors down there, so logistically we have to pay a premium to get workers in from Baltimore 90 miles away, or increase the number of units to make the deal worthwhile. With a larger labor pool we could mitigate those issues.”

Believers of supply and demand economics see a distant silver lining to the skilled labor shortage in construction: As the price of labor increases, it should logically attract more bodies back to the sector.

“It’s still a huge problem without a short-term solution, but long term as wages go up substantially it will hopefully draw new labor classes to the industry, and we’re already beginning to see some evidence to that in the percentage of female skilled laborers that make up our crews,” says Wadsworth. “It has been a noticeable difference.”

John D'Angelo

The Griswold building in Detroit has been converted from Sec. 8 housing to 127 market-rate apartments as part of a Motor City multifamily renaissance being led by Broder & Sachse.

Tech Advancements

Alternatively, major portions of multi-family construction could be removed from the traditional development process, with modular panelization plants building housing components for jobsite assembly and 3D printers and robots providing specialized manufacturing and production services alongside semiskilled, general laborers.

“In our space, success is all about speed to market and cost containment of projects,” Bach says. “To accomplish that we will increasingly need to rethink the construction process to include modular technologies and 3D printing. For every five skilled tradesmen who retire, there’s currently only one to replace them, and meanwhile we’re watching two machines fabricate a 2,700-square-foot home in less than 24 hours. The product we build is often four-story, wood-framed construction. In that world, off-site factory construction suddenly becomes very compelling and could be here sooner than we think.”

And at the very least, it wouldn’t disturb the slumbering Indiana bats.

Construction Costs: It’s All About Location

Construction costs increased last year by an average of 5.9%, according to a 12-city MSA analysis conducted by global development advisory firm Rider Levett Bucknall. Inclusive of labor, materials, taxes, and overhead, cost inflation was experienced most in cities traditionally associated with tight supply, affordability issues, or historical boom-and-bust cycles. At the micro market level, construction cost inflation is likely to be worse in secondary and tertiary markets far from established skilled labor pools and a competitive set of materials suppliers. Here’s a look at the high and low end of average multifamily construction costs per square foot in the 12 markets Rider Levett Bucknall tracked in 2018, with a comparison to the single-family sector.

	MULTIFAMILY		SINGLE-FAMILY	
LOCATION	LOW	HIGH	LOW	HIGH
BOSTON	$185	$315	$260	$360
CHICAGO	165	400	220	420
DENVER	90	200	90	410
HONOLULU	195	440	280	750
LAS VEGAS	90	405	100	350
LOS ANGELES	210	325	200	360
NEW YORK	200	375	275	400
PHOENIX	90	210	120	450
PORTLAND, ORE.	160	250	140	295
SAN FRANCISCO	375	520	230	430
SEATTLE	165	275	170	290
WASHINGTON, D.C.	200	350	300	400

Source: Rider Levett Bucknall

About the Author

Chris Wood is a freelance writer and former editor for Hanley Wood publications ProSales and Multifamily Executive.