CUSTOM CONTENT

# Construction Costs Keep Rising

## PARTNERSHIPS ARE KEY AT A TIME WHEN PROJECT COSTS ARE SKYROCKETING

By PAUL RAHIMIAN

**PAUL RAHIMIAN**
*CEO,* PARKVIEW FINANCIAL
(310) 996-8999
PAUL@PARKVIEWLOAN.COM
WWW.PARKVIEWLOAN.COM

Commercial construction projects are at all-time highs in terms of dollar volume. Across the country, projects are cropping up at breakneck speeds with the sightline of many downtown areas overflowing with cranes.

One might think this is good news. But there is a flip side to any development project. Alongside the increasing rate of construction projects comes a dramatic rise in the costs of materials, labor and land.

There are many reasons why construction costs have risen so dramatically in recent years. After the financial crisis a decade ago, most qualified workers fled the construction workforce. It was not the customary temporary departure, instead many abandoned the industry all together – never to return.

### ROOTS OF RISING COSTS

The impact of this shortage of labor was not fully realized until 2016, when a balanced economy led to a surge in construction.

As more new developments were planned, the labor demands were unable to be met. As a result, general contractors began traveling to competing sites and poaching laborers by offering them higher wages. Contractors were left with having to hire security to combat this problem. The act of "stealing laborers" was unheard of and increased labor costs at an astronomical rate. Simultaneously, developers began aggressively pursuing entitled land projects resulting in escalated land prices. The trifecta of material increases due to shortages and tariffs has resulted in amplified construction costs.

Trusted Advisors

### LENDERS FEEL EFFECTS

All these factors have affected more than the construction industry itself. They have reverberated into the world of construction lending. As costs increase, developers find themselves squeezed in terms of their profit margins. Developers are optimistic by nature and they make strong bets that local wages will rise and so will rent prices.

Developers can easily justify increased costs, hypothesizing that these movements will not reduce profits. Lenders, however, are inversely pessimistic and do not see the world through the same lens. This divergence in views causes a significant disruption in the marketplace and has led to the derailment of many projects.

Traditional banks and private lenders base their financing on a loan-to-cost (LTC) ratio. Banks may be more conservative in their numbers than private lenders, but the underlying concept is the same. Developers might wonder, if lenders base the loan amount on LTC, why would the increase in construction costs affect loan approval?

### REALITY-BASED BUDGETS

Lenders see another variable inside the puzzle, believing that construction costs inhibit the creation of profits and see developers as essentially working for free. By their estimation, the overall value of the project has not increased by the same percentage as the rise in construction costs.

Lenders may feel that, for some development deals, completing the process will not lead to the creation of any value. Although construction lenders base loan approvals on LTC, they ultimately require limited exposure on the valuation side of the deal.

So, if construction costs continue to rise, what can be done to help remedy the situation? Developers should confirm that the project budget is structured at a realistic price point. Inflated costs will end up hurting the loan prospect because experienced lenders will naturally scale the numbers back.

Further, take a thorough look at local rent statistics and do not expect growth over the next 24 to 36 months. Maybe the economy will expand and rent prices will rise, but this should be a bonus rather than an expectation. Base a pro forma loan valuation on today's values, not an artificial projection of what may happen.

### RESPECT THE PROCESS

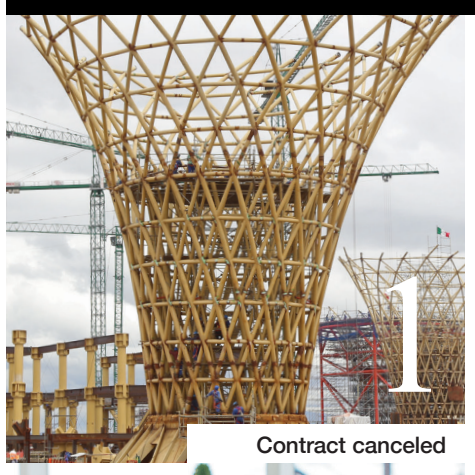
Developers should expect lenders to conduct a thorough review of the project and seek to fully understand all the development's metrics. Lenders need to give each project a fair chance. Before denying a loan request, lenders should first try to understand what the borrower is attempting to achieve. Each borrower is specific and comes with a unique set of demands, procedures, and goals.

Although it may seem like a borrower is attempting the impossible, lenders can clear up misunderstandings by executing due diligence and performing a proper site visit. They should not simply dismiss a project based on location, leverage or even the borrower's history. Although it is unreasonable to believe that every project should work for every lender, more deals can be closed by integrating creativity and flexibility into the review process.

In short, there is not much that can be done to stop the escalating costs of construction. But, by creating a closer and more efficient partnership between borrowers and lenders, more deals can be executed than ever before. By working to make comprehensive sense of each deal, the rate of closings can increase at a rate proportionate to the rising costs of construction.

LOS ANGELES BUSINESS JOURNAL

NOVEMBER 5 - 11, 2018 VOLUME 40, NUMBER 45



1 Contract canceled


6 Joyride's funding jolt

14 Social climbing

17 LAAC's facelift

35 Sweet as pie

## COVER STORIES

**MEDIA**
Katzenberg's WndrCo has eccletic start.

**FINANCE**
CBC Bancorp seeks to expand SoCal offerings.

**TECH**
Early Warning Labs looks to cash in on earthquake prediction.

**INFRASTRUCTURE**
Parsons' Mexico City airport contract in limbo.

## INSIDE

**3 ENERGY**
Possible presidential reprieve for Eagle Crest Energy project.

**3 INFRASTRUCTURE**
Edison admits equipment "associated with" Thomas Fire ignition.

**4 TRANSPORTATION**
City Council approves LAX car rental facility contract.

**5 HEALTH CARE**
L.A.'s digital health market is robust.

**6 DEALS & DEALMAKERS**
VMG Partners teams up with Chinese investment fund.

**7 RETAIL**
Milk and Eggs looks to expand in niche market.

**8 MEDIA & ENTERTAINMENT**
Patrick Soon-Shiong announces L.A. Times news channel.

**8 MANUFACTURING, RETAIL & TRADE**
Growth for Mattel in third quarter.

**14 REAL ESTATE**
Social club scene expanding with two new offerings.

**17 REAL ESTATE**
Charles Dunn Co. shutters brokerage biz.

## THE LIST

**10 APPAREL COMPANIES**
Ranked by 2017 revenue.

## NUMBERS & NOTIONS

**6 MEDIA WATCH**
**18 HOUSING DATA**
**22 LABJ STOCK INDEX**
**35 COMMUNITY OF BUSINESS**
**40 COMMENTARY/POLL**
**41 OP-ED**

Los Angeles Business Journal (ISSN: 0194-2603) © 2018 by the Los Angeles Business Journal is published weekly by Los Angeles Business Journal, 5700 Wilshire Blvd., Suite 170, Los Angeles, CA 90036. 52 issues. Business and Editorial Offices: 5700 Wilshire Blvd., Suite 170, Los Angeles, CA 90036, Accounting and Circulation Offices: Los Angeles Business Journal, 5700 Wilshire Blvd., Suite 170, Los Angeles, CA 90036. **Call (855) 293-9394 to subscribe or for customer service. All other inquiries (323) 549-5225.** Periodicals postage is paid at Los Angeles, CA 90052 and additional mailing offices. Subscription prices: 52 issues, $129.95. Single copies, $5.00. Mailed copies, $7.00. Back issues, $10.00. This newspaper is designed to inform decision-making executives, investors, and managers on trends, growth, and ideas important to commerce and industry in Los Angeles County. Information in Los Angeles Business Journal is gathered from sources considered to be reliable, but the accuracy of this information cannot be guaranteed. Neither that information nor any opinion which may be expressed here constitutes a solicitation for the purchase or sale of any securities. Opinions expressed in letters to the editor and commentaries are those of the authors and not necessarily those of Los Angeles Business Journal. Member Audit Bureau of Circulations. LABJ has been adjudicated Nov. 1985 to be a newspaper of general circulation. POSTMASTER: Send address changes to Los Angeles Business Journal, PO Box 16825, North Hollywood, CA 91615.