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Leveling off

Construction cost hikes taper, but times uneasy

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Richard Furtado, CEO, South Bay Construction, at Sunnyvale job site, sees good news in his annual cost guide.

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Silicon Valley construction costs, which have soared along with worldwide prices in the last five years, are expected to stabilize in 2008, according to a widely-followed annual projection.

But developers, architects and brokers say the easing, while welcome, is unlikely to spur a raft of new office or workplace building because of widespread marketplace uncertainty.

Under more hospitable economic conditions, flattening cost might be expected to goose new construction as landlords chase rising rents amid a dwindling supply of high-quality modern spaces.

Experienced developers like John Michael Sobrato of [Sobrato Development Cos.](#), however, say they are treading carefully. Sobrato is pursuing the entitlements to build a multi-building office campus in Santa Clara, but remains on the fence about whether to put spade to dirt for any speculative construction. He expects to decide in the next month or so whether to go forward, after he has gained city approvals.

"...I have said many times that I thought that the widely held belief we were on the verge of a boom or a strong landlord's market was broker hype and that all I was seeing was a very slow, modest, quarter-by-quarter recovery," he says in an e-mail reply to a query about the Santa Clara project's time line.

The biggest unknowns for material costs in the year ahead are the prices of metals and oil, which is an ingredient in asphalt and an underlying production cost in many other building products and services because of transportation and manufacturing uses, says J.B. Cahoon, a partner at [South Bay Construction](#), which has published the cost

projection guide since 1992. That year, it distributed less than 500 of the pocket-sized books. Last year, the company printed 5,000 copies and ran out at mid-year.

Steel prices, which have risen precipitously around the globe, look as though they are stabilizing, though construction steel remains tough to get and producers still demand minimum purchases of 1,500 tons and a year's delivery time, says Richard Furtado, South Bay's chief executive. A ton of steel now costs about \$3,800, assuming a relatively large order.

In 2004, the company budgeted steel at about \$2,400 a ton.

"There has always been a lead time for steel, but it's gotten really difficult to get in the last several years because they've changed the manufacturing process, and you essentially have to get into a line," Furtado says.

Skilled labor costs for workers such as forklift operators and electricians also are a consistent, typically annual upward pressure on construction costs, but Furtado says that for the first time in four to five years, he had begun to receive resumes from site superintendents, project engineers and others who typically work in residential construction but are looking elsewhere for work. The net effect, he believes, will be downward pressure on labor prices.

None of this is to say that dramatic geopolitical or weather events such as another massive hurricane can't throw the current projections off, both men say. But year in, year out, they and the booklet's users say the price estimates have proven a reliable predictor and starting point to determine if a building or project makes financial sense given the current rents and workplace vacancy rates.

"It will be interesting for me to see what happens in the next six months," Furtado says. "I don't see all of that 15 million square feet or so (in speculative office development once discussed) happening."

Erik Hallgrimson, a senior vice president and principal at Santa Clara's [CPS Commercial Property Services](#) who uses the cost projection guide booklet regularly, tends to agree. Many people continue to think Silicon Valley workplace rents will rise, but the question has become how fast, he says. Net absorption -- the difference between what tenants leased and returned to market -- averaged about 3 million square feet a year for research and development properties in 2004, 2005 and 2006, driving vacancy rates down, he notes. Research and development buildings are the valley's most common with about 150 million square feet on the ground, though that sum varies depending on where the valley's boundaries are drawn.

Last year, the powerful tenant-leasing trend, which was behind the rising rents, faltered, and while the year overall saw positive net absorption, it was at about half the pace of the previous three, Hallgrimson says. The fourth quarter in particular was very weak, with negative net absorption, raising questions about first-quarter performance and whether

tenant demand has sharply cooled or companies put off decisions at the end of last year but still have unmet space needs.

"If you saw construction costs drop dramatically, you wouldn't need as high a rent to justify development, and it would make new development a lot more competitive (with existing buildings' rent). But as long as construction costs remain the same, you still need north of \$3 (a square foot in rents to justify new construction), which is hard to get for a lot of landlords in today's market," he says.

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