



2023 Q2

# THE LOOK AHEAD

## Market Overview

Several indicators were more robust than expected in Q2. New home sales, builder confidence, and earnings data were all higher than anticipated. In addition, the unemployment rate fell. Each of these points to more growth and upward price pressure. In contrast, we also saw consumer spending ease slightly, some early signs of labor market cooling with fewer jobs added, and fewer job openings. These factors contributed to the inflation reduction we saw reflected in June's Consumer Price Index measurement, but they are still relatively elevated and will need to ease further. Recession fears still linger as strength on the retail side, particularly services, is contrasted with weakness in other sectors such as manufacturing. Rates will continue to remain elevated as the Fed waits for more data to decide the terminal rate for this hiking cycle.

## THE NASHVILLE MARKET

While we have continued to see economic turbulence and interest rate variation across the country, the Nashville market continues to be resilient and diverse in comparison to other markets. While we have seen certain asset types continue to slow down from an activity standpoint (office and retail), we have also continued to see uncommon growth for our region in the form of other market sectors (multifamily, industrial, healthcare, etc) as well as through unique large-scale, high-profile projects active in the region (EV battery, Data Centers, Airport Expansion, and Professional Sports). While there has been market anticipation around these high-profile projects, we are just now starting to see the impact of those on the market and anticipate that impact will continue for some time.



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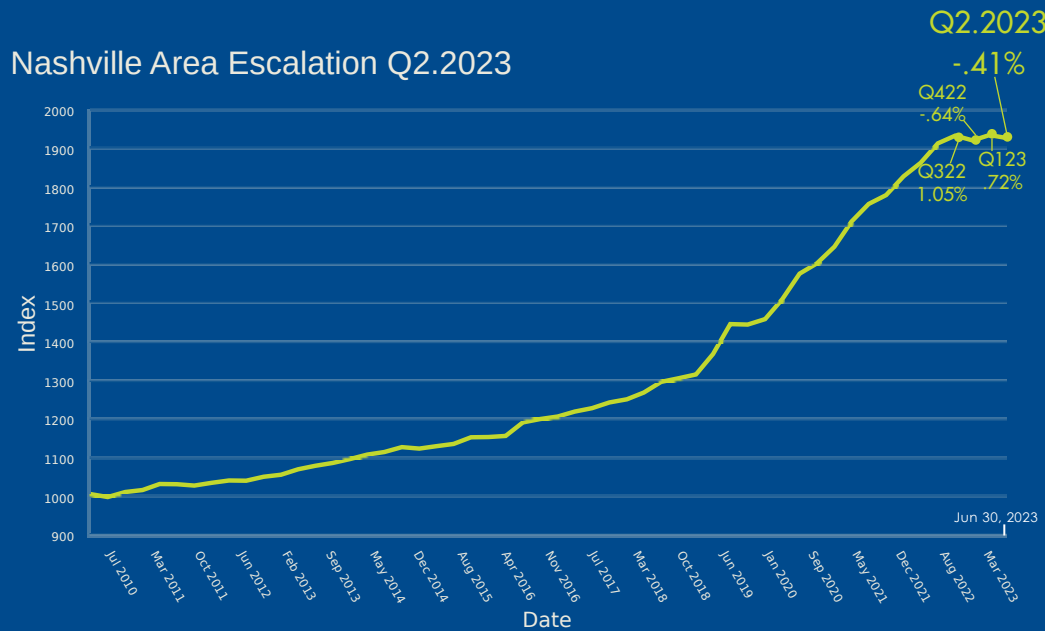
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## Nashville Area Escalation Q2.2023



From a pricing standpoint, overall pricing again remained relatively flat for Q2. Overall material pricing has become more stable which is made up of some specific key materials reducing in cost while others continuing to seeing smaller price increases.

We have also seen some softening in material lead times in certain areas as well as some stabilization in commodities which has helped. However, we still anticipate seeing expanded lead times on manufactured products and major mechanical & electrical equipment for the rest of 2023 and possibly beyond which will continue to put pressure on project budgets and schedules. Labor demand in the market continued to increase over the 3rd quarter of 2023 similar to what we have seen throughout the first half of the year but it is our belief that those increased labor costs were likely offset by the improvement in materials and commodities leading to a flat quarter.

### LABOR & MATERIAL TRENDS THIS QUARTER

Labor Wage Change		Material Price Change	
Carpenter	1.07%	Fabricated Steel	-1.26%
Laborer	1.00%	Fabricated Copper	-11.85%
Sheet Metal Worker	0.00%	Fabricated Aluminum	-15.67%
Plumber/Fitter	0.00%	#2 Diesel Fuel	-9.36%
Electrician	0.00%	4,000 psi Concrete Ready Mix	-2.99%
Bricklayer	0.00%	Lumber, FOB Jobsite	-8.22%
Iron Worker	0.00%	Glass	-0.04%
Glazier	5.10%	Sheet Metal	1.72%
Roofer	0.00%	Gypsum	37.37%
Operator	13.51%	Other Materials	0.15%

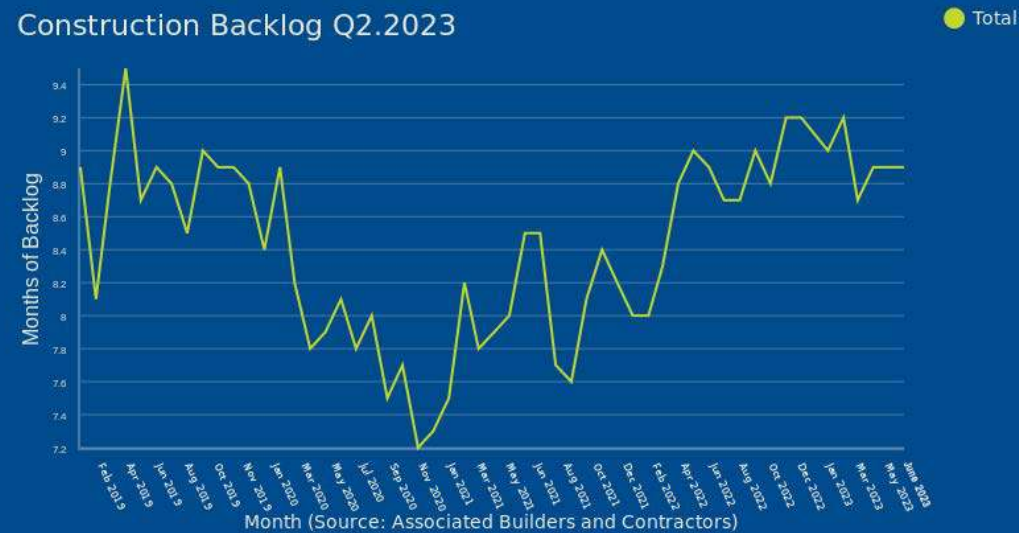
*Other Materials consists of brick, block, precast insulation, floor covering, ceilings, and Miscellaneous materials*

# NATIONAL CONSTRUCTION INDICATORS ACTIVITY & PRICING METRICS

## Architectural Billings Q2.2023



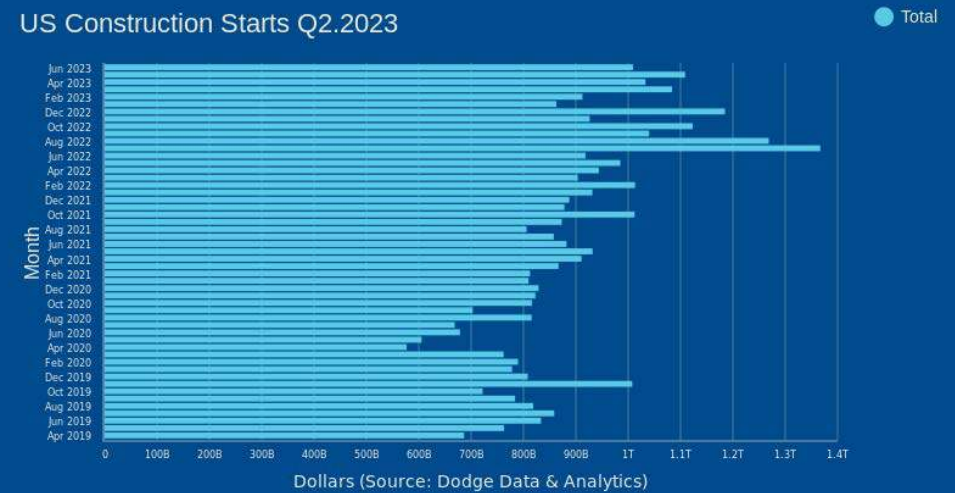
## Construction Backlog Q2.2023



## Commodities Pricing Q2.2023

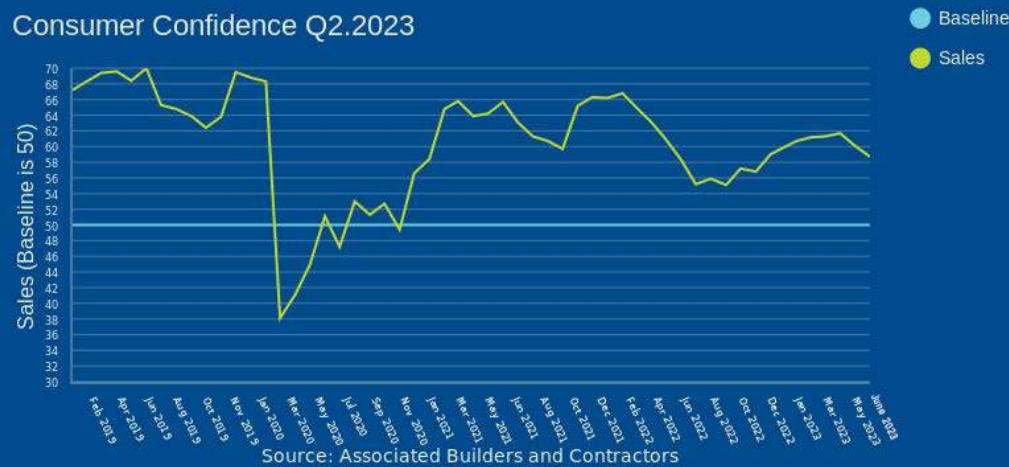


## US Construction Starts Q2.2023

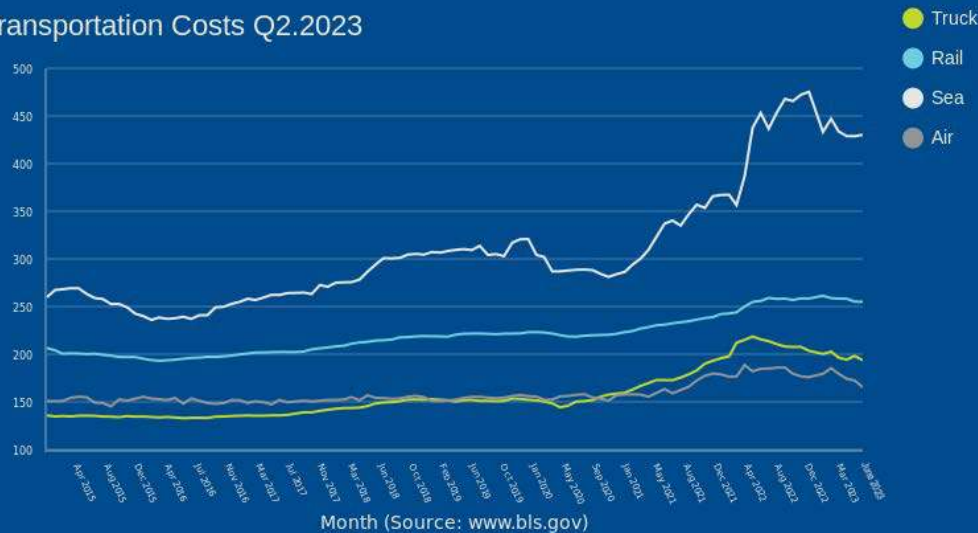


# NATIONAL CONSTRUCTION INDICATORS ACTIVITY & PRICING METRICS

Consumer Confidence Q2.2023



Transportation Costs Q2.2023



## ESCALATION SNAPSHOTS

To give you an idea of how escalation is impacting different parts of the country, here is a snapshot of the escalation changes our offices reported specific to their markets in Q2.2023.

- Atlanta, GA: **+0.14%**
- Austin, TX: **-0.24%**
- Charlotte, NC: **+0.50%**
- Dallas, TX: **+0.62%**
- Denver, CO: **+0.98%**
- Houston, TX: **+0.48%**
- Kansas City, MO: **+0.04%**
- Minneapolis, MN: **+2.14%**
- Nashville, TN: **-0.41%**
- Oklahoma City, OK: **+1.0%**
- Omaha, NE: **-0.72%**
- Phoenix, AZ: **+0.28%**
- Portland, OR: **+1.5%**
- Savannah, GA: **+0.87%**
- Tampa, FL: **+0.55%**
- Williston, ND: **+2.27%**

## FUTURE ISSUES

As feedback and market-specific questions have been posed, we are always enhancing the depth and type of information The Look Ahead features. Please [click here](#) to send your comments and requests.

## COMMERCIAL DEVELOPMENT

The Federal Reserve continues to raise interest rates to tame inflation, hoping to reach the tipping point where the economy stops growing and starts to contract, thus tamping inflation. Their latest adjustment increased the federal funds rate to a range of 5.25% to 5.5%, which is the highest level in 22 years. Now that we've arrived at that point, it seems the headlines on lending and development are doom and gloom, but is that really the case?



In this Spotlight, Michael Walden (left) and Chris Hermreck (right) of JE Dunn Capital Partners (JEDCP), discuss commercial development trends they are seeing in several markets. JEDCP is the real estate investment arm of JE Dunn Construction and to date, they have sourced over \$1 billion of equity and debt in construction projects through developer partnerships and a strong lending network. They will also share their strategies to navigate the latest challenges of real estate lending.

## MULTI-FAMILY

The demand for rental housing has grown significantly in the past several years. This growth has been reflective of an increase in discretionary rental households or “rent-by-choice” households. People choosing to rent in lieu of home ownership cite flexibility to move and disinterest in home maintenance as the top reasons.

And it isn't just younger, single Americans in urban areas making this choice. Young families, seniors, and the suburbs appear to be shifting away from traditional ownership. According to Harvard's Joint Center for Housing Studies (JCHS), the number of renters making at least \$75,000 annually jumped by 48% over the last decade ending just before the pandemic, to 11.3 million. With this increase, the share of renter households in this income group rose from 20% to 26%. **These types of trends, in addition to an ongoing overall housing shortage in the U.S., are making multi-family a strong asset type for the foreseeable future.**

## OFFICE

We do not anticipate growth in the office market in the next few years. Most companies are still striving to strike a balance between physical office space, which can be crucial to a company's culture, and employee demand for flexibility. The office sector's traditional, long-term lease structures have allowed this extended experimental phase to play out. In any scenario, the future of work is likely to contain hybrid elements. Surveys indicate the average office employee will work in-person 3 to 3.5 days a week in the years ahead. As long as the labor market remains tight, employers will likely have to accommodate. Meanwhile, office vacancies are trending upward in many major cities and will likely continue to do so as more lease terms expire. This trend will continue to stress the office valuations and associated refinancing options. The full outcome of these stressed assets may not be fully realized for several years ahead and therefore office sector will be challenged for the foreseeable future.

## HOSPITALITY

This market is making a moderate comeback post-pandemic. Mid-week travel patterns have begun to show promising strides toward a more sustained recovery. High demand locations are recovering quickly, corporate travel spending continues to increase, and international travel is picking up as well.

## MEDICAL OFFICE

Due to the increasing number of insured people following the introduction of the Affordable Care Act of 2010, as well as an aging population, the demand for medical services has continued to grow significantly and the shift to outpatient care has been concurrently increasing. Primary reasons for the shift to outpatient care include advances in technology, changes in reimbursements and consumer preferences.<sup>1</sup> In-person visits currently account for 90% of all healthcare visits. Telehealth peaked at 52% during the Covid pandemic and quickly dissipated back to 10% today.

From 2016-21, the share of outpatient Medicare payments increased from 28.5% to 33.3%, with the greatest growth coming from surgery and dialysis. This type of patient care growth has also contributed to the demand for outpatient care. Spine, orthopedic, and vascular care are other areas of patient care experiencing substantial growth. Given these stats, medical office has been one of the most active asset types since interest rates have spiked. We foresee sustained sector growth for the immediate future.

## STUDENT HOUSING

Student housing rent growth and occupancy were at all-time highs in the Fall of 2022. While difficult to measure whether these trends are sustainable, the return to normal campus life appears to be steady for the near term. This property sector continues to see institutional capital flows as the largest Real Estate Investment Trusts (REITs) and asset managers enter the space.



## REAL ESTATE INVESTMENT TRENDS

The historic rapid increase in interest rates over the last 12 months has challenged the real estate investment markets. This trend has created a lot of uncertainty and therefore has been limiting the transaction volume in the commercial real estate markets. In addition to the interest rate disruption, many regional banks are dealing with additional scrutiny in the aftermath of the collapse of Silicon Valley Bank, Signature Bank, and First Republic Bank. Reuters notes "regional banks, the largest

lenders to the beleaguered U.S. CRE and construction markets have reduced their exposure to the sector by tightening standards and making fewer loans." <sup>2</sup> With these headwinds, it has become more challenging to find lenders and equity groups that are willing to partner on projects given challenged investment returns.

With this being said, there has been a recent decline in new project starts after the U.S. has seen record amounts of supply for both multifamily and industrial projects. Slowing supply in 2025 may drive continued

opportunity for developers to start new projects in the next three years. Investors are still "viewing multifamily as a safer place to park capital than other investment products or other commercial property classes such as office or retail."<sup>3</sup> In addition, "Multifamily investors are increasingly favoring markets that not only provide population and job growth but also have less political risk. Large coastal states have more areas subject to rent controls and are more likely to pass new laws that impact investors' "bottom line."



*The Hilton Canopy Hotel in Austin, Texas is one of JE Dunn Capital Partner's hospitality projects.*

In this environment, it is critical to have trusted financial partners with history of successful execution. Despite the challenges in the market, the limited number of new developments may create upcoming opportunities for delivering new product into an under supplied market at the right time.

## KEY TRENDS

### CHALLENGES

Rising interest rates adding project financing costs.

Market uncertainty with rising rates.

Recent regional bank panic and tightening.

Limited real estate transaction volume.

Reduced office demand.

Closing a deal (equity, debt, and GMP) is incredibly difficult.

### OPPORTUNITIES

Distress and disruption can create windows of opportunity.

Resilient demand for high-growth markets.

Limited new starts = less competitive supply when delivered.

Large investors and real estate funds have record levels of capital to deploy.

JE Dunn brand and creditworthiness.

JEDCP deep relationships with banks and equity partners.

## NAVIGATING CHALLENGES

So what should investors look for when choosing whether to proceed with a new investment and deciding which assets offer attractive returns with minimal risk? There is no easy answer. However, establishing partnerships with trusted and experienced partners is the right first step.

Teaming with the right partners sets a strong foundation for collaboration, efficiency, and risk aversion. Projects setup the right way, will see less hiccups and more focus on the best interests of the project.

Second, utilizing a diversified and strong lending network can help protect you from large-scale turbulence outside of your control, perfectly exemplified by the recent banking crisis. This isn't always an easy task but having a strong enough balance sheet and a good relationship with your lenders can afford you the ability to use multiple funding sources.

Next, project and product type experience. By selecting development, design, and construction firms specializing in the desired product type, you can expect a team who will foresee and proactively mitigate typical challenges of pricing and building these projects. For example, selecting the most optimal multi-family finishes to maximize the quality of the units, thus maximizing rents, while minimizing the cost premium. Other examples, would be selecting the most optimal (price & performance) HVAC system based on the building parameters. Furthermore, leveraging an integrated approach with trade partners to lock-in pricing early to mitigate cost escalations and concurrently release long lead equipment to fast-track the overall schedule.

Last, look for teams with specific experience in the desired local market and network. The knowledge they have of local building codes and other governance issues paired with trade partner relationships, will prove valuable. Trust is at the foundation of every successful construction project and having it already established within the area you are building, protects the project from potential schedule delays.

JE Dunn Capital Partners believes these challenging times create opportunities. We take a flexible and long term approach when evaluating deals. We are fortunate to work alongside our JE Dunn Construction teams to leverage their strength and knowledge to continue delivering excellence in the commercial development space.



# CAP RATES

Cap rate is short for capitalization rate. It's used to evaluate risk, determine what kind of return on investment a property can provide, and provide insight into the type of market that you're dealing with.

## How do we use cap rates?

You can calculate the cap rate by dividing whatever net income an asset generates by the value of the asset. For example, an apartment building that brings in \$600,000 in rent per year and has \$200,000 worth of expenses per year has a cap rate of 8%. You would first subtract expenses from the \$600,000 of gross income to get \$400,000 in net income. You would then divide net income by the value of the asset, which is the current market price (\$5M) in this case, to get a cap rate of 8%.

## What does the cap rate tell us?

You can use cap rates to estimate your return on investment for a property. In our example, if we bought the apartment building for \$5M, we could expect a return of 8% per year on that investment since the net income it generates is 8% of the purchase price. Another way to think about this is that it tells you how long it would take for you to recover what you paid. With an 8% rate, it would take 12.5 years to recoup your investment.

## What is a good cap rate?

This of course is an extremely subjective question that would depend on the investor's goals. The rule of thumb is that lower cap rates mean lower risk and higher prices while higher cap rates mean higher risk and lower prices. Depending on the asset, a cap rate of 5% or below would be considered low risk and 7% or above would be considered high risk. If an investor is looking for a deal on a piece of property, they would likely try to find it in the high cap rate ranges but if they wanted a safer investment, a low cap rate would be more appropriate. Most often we are working with clients/owners who are developers who will want to sell a completed project for a low cap rate.

The cap rate can reveal risk built into the market value (or sales price in our scenario). The market value for our apartment building was a little high at 8% when the price was \$5M. What if the price were \$10M? Then our cap rate goes down to 4%, something we would label as less risky. The price is higher in the second example and that's where the risk is hidden. It could be because the apartment building is in a different area; maybe in the first scenario (priced at \$5M) the area has a high crime rate, is in an out-of-the-way location, or the building is run-down. Whatever it is, something is driving the price down compared to the second scenario (priced at \$10M) and that something can be thought of as the theoretical risk that isn't always explicitly disclosed. Cap rates give you the ability to compare that non-numeric attribute quickly and easily.



# CURRENT EVENTS

## Supply Chain And Material Pricing

As the supply chain has stabilized, material prices have not receded as you would hope. Why? In our regular calls with trade partners and material suppliers, it comes down to fear. Fear of committing to a price and then experiencing large swings or volatility in pricing. The outlook is improving as 75% of our trades report steady pricing last quarter. In this section we will dig into what we are seeing in the market for lumber, steel, and concrete and the subsequent effect on pricing.



## LUMBER

### Construction Input Prices

The Producer Price Index (Chart 1) for softwood lumber resembles a roller coaster since the beginning of the pandemic.

Prices shot up 166%, then plummeted 48%, then jumped up 71%, and then slowly cooled again to where prices are now only 22% higher than January 2020 levels. Compared to the relative stability of the previous decade, this has been an extremely volatile material. SEE CHART 2.

Obviously, the pandemic had an enormous effect on lumber pricing and availability. Housing makes up a

large share of the lumber demand and, after an initial drop, the demand for homebuilding was very strong up until around the second quarter of 2022. The labor strain in mills and lumber yards resulted in prices skyrocketing as output was extremely low and couldn't keep up with demand.

As homebuilding demand began to wane in May of 2022, lumber prices came down as well.

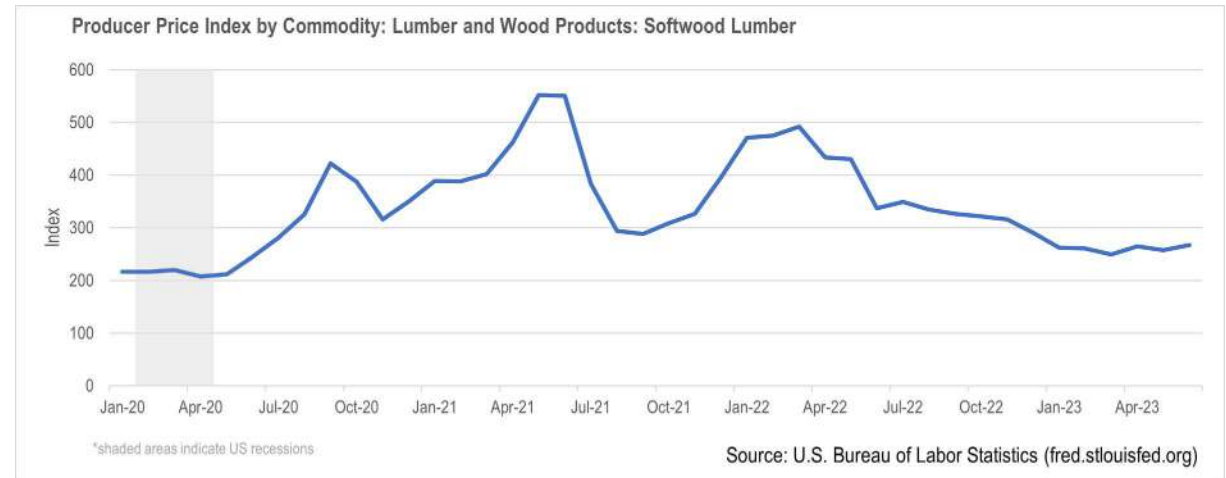


CHART 1: LUMBER PRICES SINCE APRIL 2020



CHART 2: LUMBER PPI SINCE 2014



Homebuilding continued to decline through the end of 2022 but as existing housing inventory dwindles, homebuilding looks to be stabilizing. SEE CHART 3.

What can we expect for lumber prices going forward? We should see some reduction in volatility as overall demand eases. On the supply side, production capacity and output have found their footing again, as disruptions initially caused by furloughed workers followed by the slow on-ramping time for new mills needed to meet demand have been

largely ironed out. A cooling labor market in general will help prevent supply-side snarls as well. Demand-side shocks from China are a threat, but not nearly to the degree that we have recently experienced.

Our forecasting partner, Moody's Analytics, has the Producer Price Index for lumber falling slightly through the end of 2023 (SEE CHART 4) and then rising again in the back half of 2024 as construction and homebuilding demand begins to strengthen (forecast values in light grey).

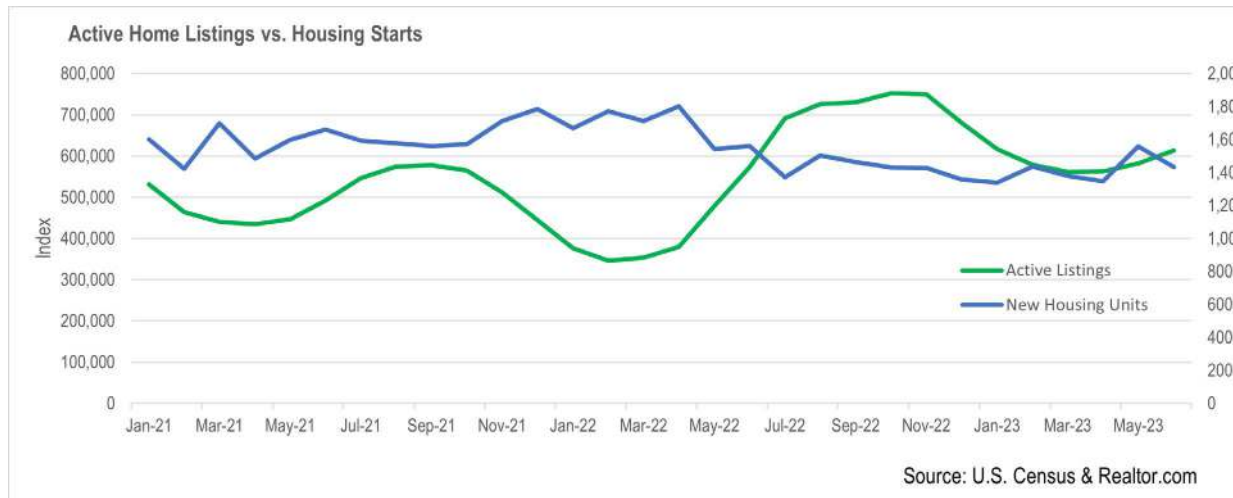


CHART 3: HOME SALES AND NEW HOME CONSTRUCTION

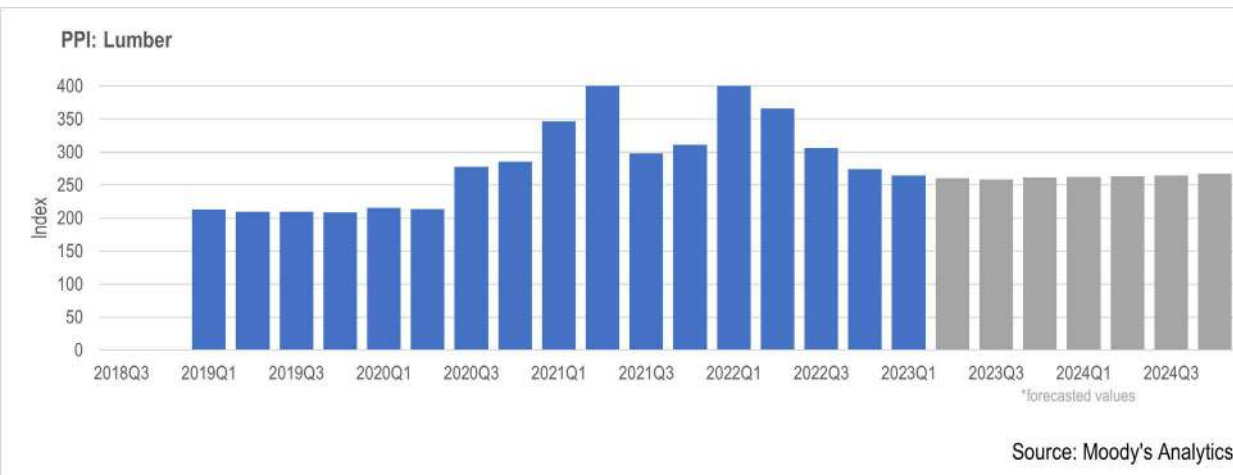


CHART 4: PRODUCER PRICE INDEX FOR LUMBER (ACTUAL AND FORECASTED)



# STEEL

## Construction Input Prices

Unlike lumber, steel has stayed closer to its mid-pandemic peak, and though it did trend downward for eight consecutive months, it has since rebounded again.

SEE CHART 1.

Most steel production happens in two ways: 1) from integrated mills that use blast furnaces to melt iron ore, limestone, and coke to make new steel or 2) electric arc furnaces (EAF) produce recycled steel from steel scrap and waste. During the early stages of the pandemic, mills reacted quickly to the sharp decline in demand by shuttering furnaces, which severely reduced capacity—by approximately 40,000 daily tons (mostly on the integrated mills side). Once demand resumed, supply was extremely low and the mills' ability to ramp production back up was hampered, sending prices soaring. In three months, the price index for steel mill products increased by over 150%. SEE CHART 2

Although prices have moderated a fair amount, prices remain roughly 75% higher than their pre-pandemic levels. Somewhere around 10,000 to 12,000 tons of capacity from integrated mills never came back online, resulting in the need

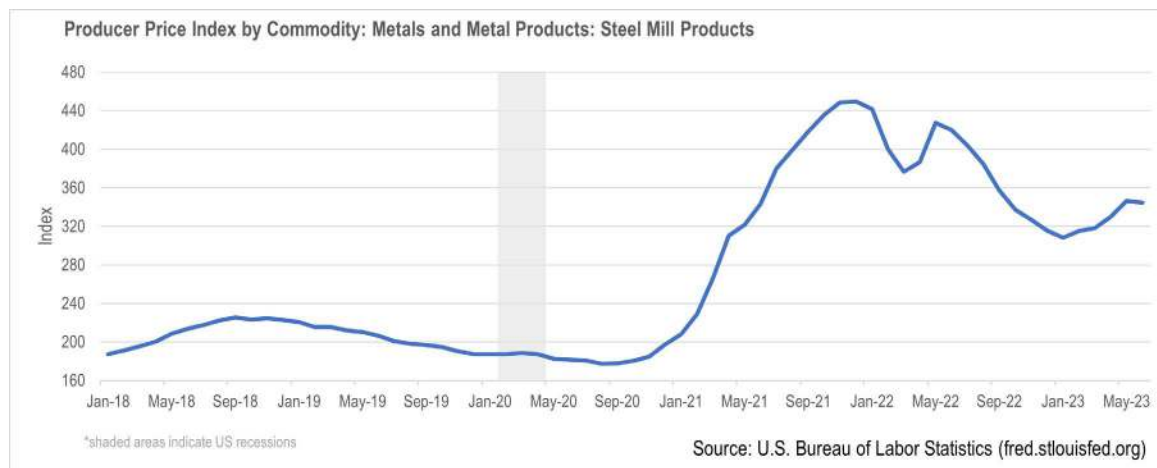


CHART 1: STEEL PRODUCER PRICE INDEX

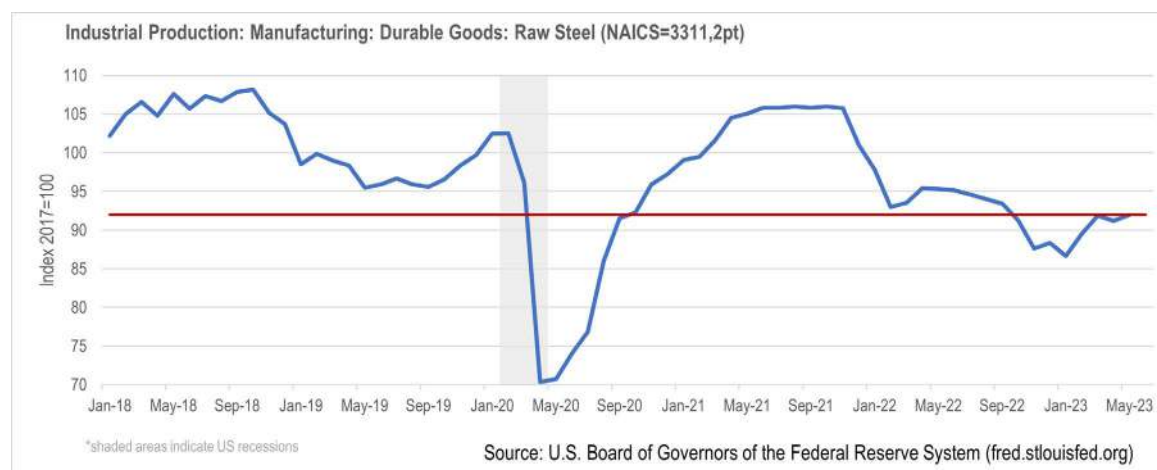


CHART 2: STEEL PRODUCTION

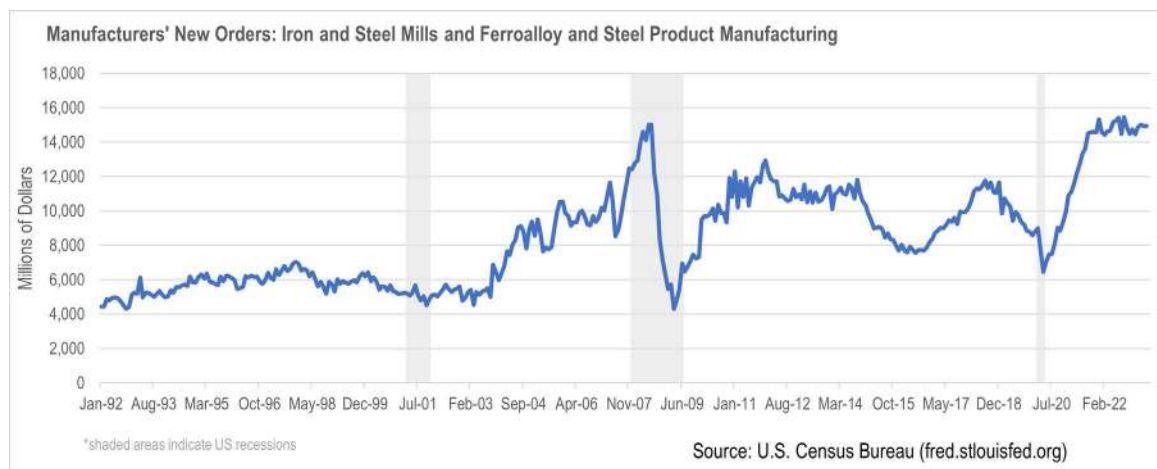


CHART 3: STEEL NEW ORDERS

for electric arc furnaces to increase production, putting more pressure on scrap demand. Production is still not back to prior trend levels. For manufacturing, new orders for steel products are hovering near all-time historical highs and backlogs are still elevated. SEE CHARTS 3 & 4.

Production levels are forecast\* to slowly increase and come closer to equilibrium as demand spikes ease. SEE CHART 5.

Prices should settle to their new normal, although more volatility will likely exist than the forecast shows as pricing is still being quoted at shortened intervals. This allows producers the ability to ramp up quickly if necessary.

\*We work with Moody's Analytics to provide forecasts and other forward-looking data.



CHART 4: STEEL BACKLOG

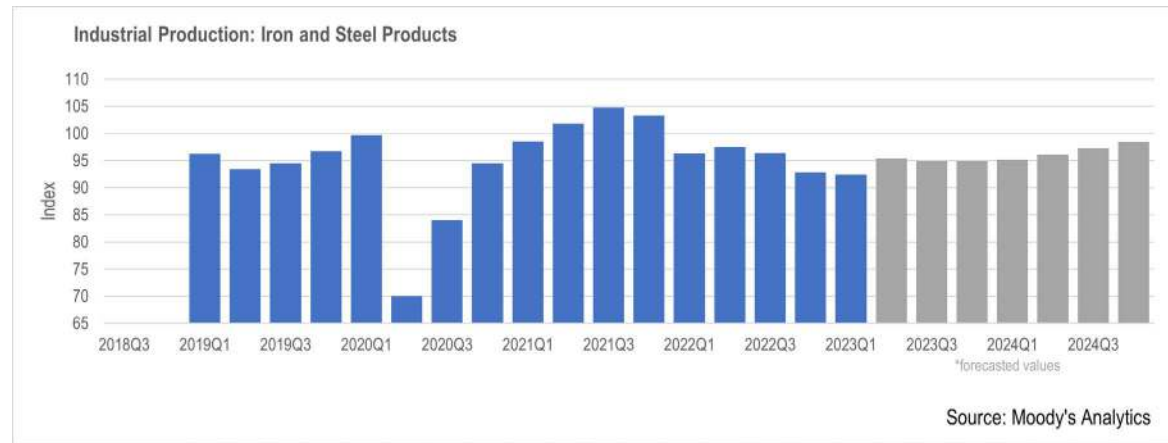


CHART 5: STEEL PROJECTIONS



# CONCRETE

## Construction Input Prices

Ready-mix concrete (RMC), along with steel, copper, and lumber, is one of the “big four” components of our Quarterly Cost Index, accounting for roughly 7% of the materials featured in the index. Prices for RMC are roughly 28% higher today than pre-pandemic levels so this one element can have an outsized impact on the total bill for construction.

We track concrete in the ready-mix product form as it is extremely common in vertical construction, but it also allows us to view it as one fungible product instead of following the prices for the individual materials separately.

Several commodities have shown price fluctuations, but that hasn’t been the case for RMC. The aggregate (yes, a concrete pun) price level has increased in all but two months over the last two years. Regionally, prices have increased the most dramatically in the West since the beginning of the pandemic. SEE CHARTS 1&2.

What is keeping concrete prices so consistently high? Why haven’t we seen any kind of moderation in prices?

Let’s first look at the cost drivers for concrete. Concrete is made up of a fairly simple list of ingredients: Portland cement (a specific type of cement—sort of like stainless steel is a specific type of steel—made up mostly of crushed limestone and silica); sand and gravel aggregates (our pun from earlier); and water.

It also takes an extremely large amount of energy to produce concrete, particularly when making the

Portland cement component, and most producers use fossil fuels for that energy.

Now, for our overall list of construction inputs, supply chain stress and logistics issues that hampered inventories and availability, along with the increased levels of demand, are the fundamental factors that drove prices up for most materials. Lumber prices declined thanks in large part to the fall in demand



CHART 1: PRODUCER PRICE INDEX: CONCRETE

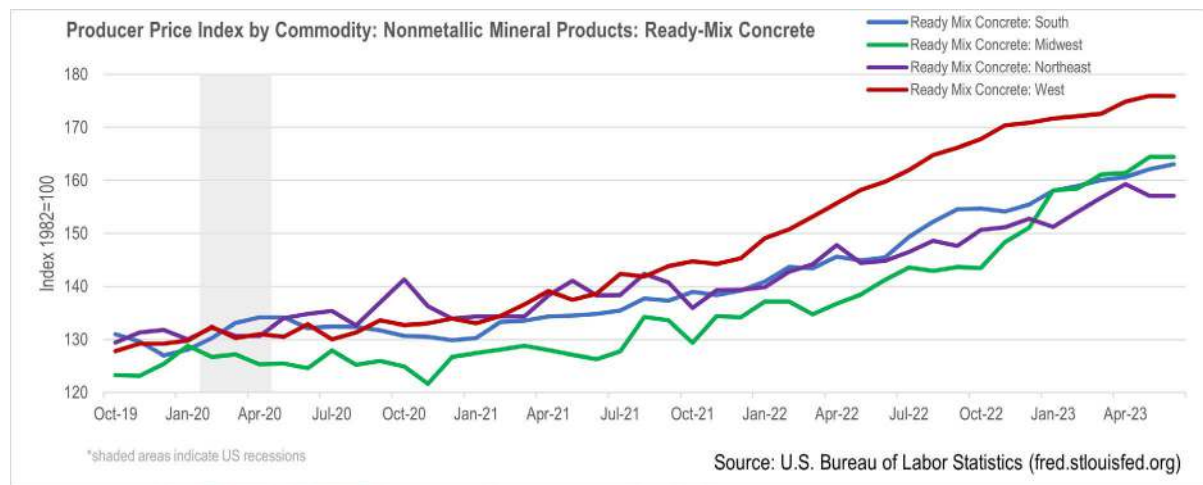


CHART 2: PRODUCER PRICE INDEX: CONCRETE BY REGION



that came from the housing downturn, particularly on the single-family construction side (labor supply and mill productivity played a role too of course). For steel, producer prices (cost of inputs) came down for a time, allowing market prices to ease somewhat. We haven't seen either of those things happen at scale for concrete. Demand has stayed elevated (thanks to the construction sectors that have flourished, such as manufacturing) and input prices for things like limestone and, for a time, energy have helped push prices further up.

The rising cost of the fuels used for producing concrete added upward pressure on prices from the beginning

of 2020 through roughly the summer of 2022. Energy prices have since fallen, and we still haven't seen price relief for concrete. The rest of that upward price pressure is coming from the crushed limestone and aggregate costs. Those costs have continued to increase in response to demand, and there hasn't been the same kind of supply-chain-easing impact because crushed stone markets are very local. For instance, they aren't nearly as trans-continental as lumber. When a product is more mobile, it's more substitutable, so price changes for more localized products are much slower to come about. It took prices for RMC longer to increase compared to other inputs and, by the same token, it will take them longer

to decrease when compared to other inputs. As long as demand remains strong, so will prices.

SEE CHART 3.

The forecast for concrete is steady. Demand will likely slow over the next few quarters but not drop to the point where we would see concrete prices come down. Prices will continue to increase, just at a slower rate. As the economy transitions to a more expansionary environment in 2025, price increases would likely reaccelerate.

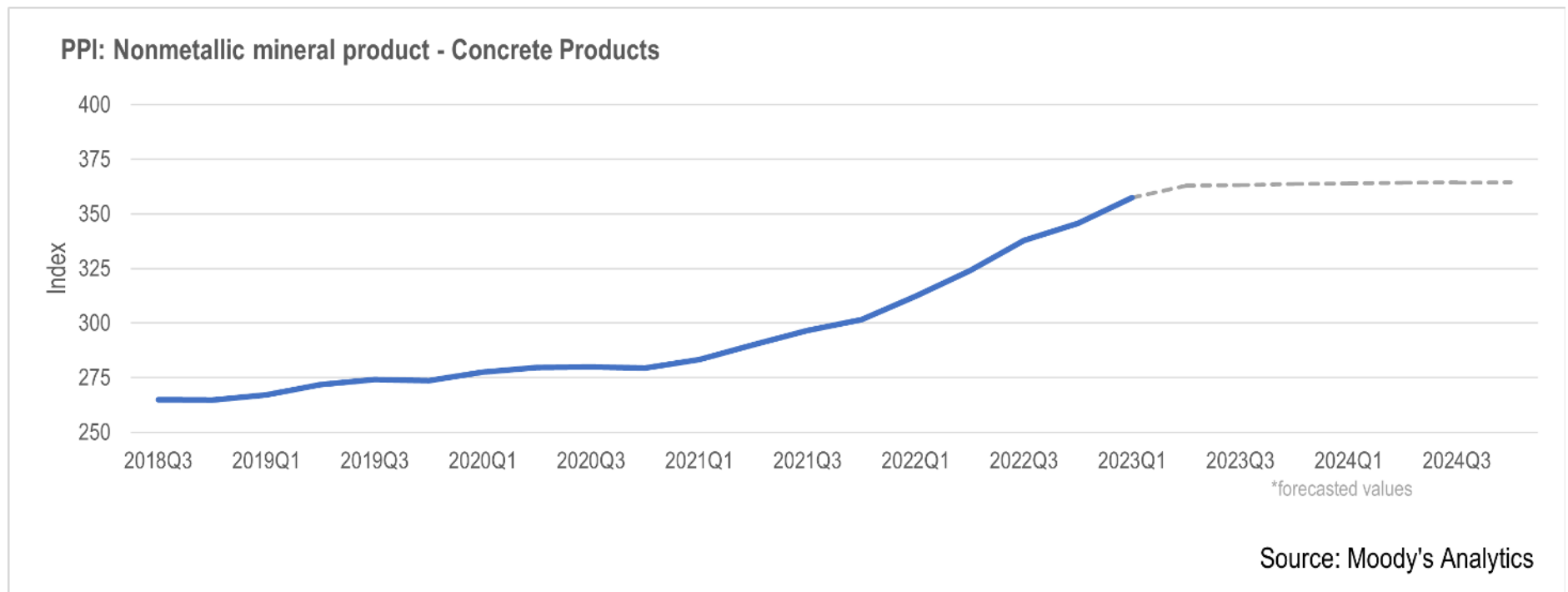


CHART 3: PRODUCER PRICE INDEX: CONCRETE FORECAST