



## MEMORANDUM

To: Interested Clients / Stakeholders in the Affordable Housing Development Sector

From: Mike Steffen, General Manager / Ed Sloop, Chief Estimator

Date: June 2, 2017

Subject: Current Market Conditions and Impacts on Construction Costs

cc: WALSH Project Managers

At the request of several project partners in the affordable housing development community, WALSH has developed the following commentary (in Q&A format) regarding current market conditions we are observing that are having significant impacts on the costs of multifamily housing projects in the Pacific Northwest during the first six months of 2017.

***Question: It appears that every project these days is feeling the impact of severe cost escalation. Is there a way that Walsh can quantify 1) the number of properties under development that are experiencing construction inflation, and 2) what those properties are experiencing as a percentage of inflation and overall cost increase?***

Answers:

- We analyzed all multifamily (MF) housing projects in our pipeline over the past year. These are new construction projects only. We did not figure rehabs here. There are 14 projects total: 11 are affordable projects, 3 are market rate.
- Listed below are the 14 MF projects, with approximate unit count. Note that we have generally listed here the increase in estimated cost over roughly a one year timeframe, however with some we only listed the increase over a few months' time since we've not had many estimates yet. We have not yet determined the estimated percentage due just to cost escalation. The increase figure for the most part is the result of both design development, AND the escalation of costs within the individual trade items, and higher GCs as impacted by longer schedules. However, as all developers know, project costs are affected by many factors and there is no "consumer price index" for any one project. The figures below are our best effort at determining what each project experienced.

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- Project A – 210 unit affordable project (13% increase from Feb. 2017 – May 2017)
- Project B – 50 unit affordable project (17% increase from Jul. 2016 – May 2017)
- Project C – 36 unit affordable project (10% increase from Dec. 2016 – May 2017)
- Project D – 120 unit affordable project (7% increase from Jan. 2017 – Apr. 2017)
- Project E – 50 unit affordable project (13% increase from Apr. 2016 – Apr. 2017)
- Project F – 170 unit market rate project (16% increase from Aug. 2015 – Oct. 2017)
- Project G – 210 unit market rate project (18% increase from Jan. 2017 – Mar. 2017)
- Project H – 150 unit affordable project (12% increase from Dec. 2016 – Mar. 2017)
- Project I – 140 unit market rate project (9% increase from Aug. 2016 – Mar. 2017)
- Project J – 60 unit affordable project (10% increase from Jun. 2015 – Aug. 2016)
- Project K – 240 unit affordable project (6% increase from Aug. 2016 – Jan. 2017)
- Project L – 60 unit affordable project (12% increase from Apr. 2016 – Apr. 2017)
- Project M – 50 unit affordable project (9% increase from Apr. 2016 – May 2017)
- Project N – 30 unit affordable project (9% decrease from Nov. 2016 – May 2017)

- Of these 14 projects, only 1 out of 14 decreased in value during the course of design and this was due to a major redesign, and significant VE effort on top of that.
- The data suggests that nearly all recent WALSH multifamily (MF) projects, whether affordable or market rate, have experienced escalation, some well above historic norms, and we believe well above what average escalation is in the general construction market. In our view, this is primarily due to the unique nature of the subcontractor pool that serves the MF sector (more below).

***Question: The cost escalation issue appears to be hitting multifamily housing specifically. Can Walsh help us understand why it's important not just to look at construction inflation across the construction industry as a whole, but instead why it's important to consider the issue in multifamily in particular?***

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Answers:

- As compared to the commercial/institutional construction market the multifamily (MF) market is served by a less sophisticated sub base, with less infrastructure (capacity) to deal with increased demand. On one hand, there are more subcontractor firms, however they tend to be much smaller in size than commercial/institutional oriented firms, less capitalized and less developed.
- This subcontractor base is less motivated to pursue/bid work on affordable housing projects as compared to market rate projects. This is due to the requirements (i.e. "red tape") involved. Privately financed, market rate work is much less encumbered and looks much more attractive to the MF sub base, especially in the heated market we have now. Thus, they pursue market rate work and many subs completely avoid the affordable projects. This of course will change when the housing market turns, the market rate work dries up, but we are not there now.
- There is a severe shortage of both skilled and unskilled labor in the PDX construction market, leading to wage increases, which obviously drives up labor costs. But it also leads to the inability of subs to pursue a greater volume of work since they do not have the manpower. This in turn makes the subs less hungry, and more likely to increase profit margins.
- The acuteness of the problem is local, NOT national, thus we believe it is not reflected in national cost index surveys.
- PDX has been one of the fastest growing markets in the country (due to number of people moving here). In turn, developers have followed the opportunity which has created an imbalance between supply and demand due to the increase of construction activity.
- Increased demand in the market – leading to more hiring – has also effectively reduced the productivity of the average crew. Shortages of manpower, combined with lower productivity, have caused construction schedules to extend beyond past norms. This too has driven costs upward.
- Some subcontractor firms are charging more because they can in the current market, but that doesn't seem to be the largest driver. Our opinion is that most of the movement is from loss of productivity and individual business owners raising their prices to make ends meet.
- The published cost indexing / escalation figures are back looking and our budgeting processes are forward looking and based on current and very recent historical cost data i.e. since the beginning of 2017.

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- Subcontractors are not as willing to travel as far to do the work which, in effect, reduces the sub pool at any particular site. This is because business owners want to retain talent and, all other things being equal, if they have work closer to where their people live their people are happier and more likely to remain with them.
- Even jobs that are willing to pay for OT can't get people to necessarily do the work thus schedules have gotten longer which in turn drives up the cost of general conditions.
- Material escalation is a factor also, though generally less acute problem than labor costs and markup escalation. Steel, copper, drywall all have been increasing steadily for several years. We now have a very unstable situation with lumber market prices due to the current administration's trade policies and that is having a significant hit on wood frame MF jobs.

***Question: Why do we seem to be seeing inflation between 6% to 8% (if that's current still) for commercial, manufacturing, schools, general light industrial, hospitals, etc. but we are seeing 10% to 15% on multifamily?***

***Answer:***

- National cost indexing surveys are indicating 4-6% increase nationally in the building construction market. Only one national firm tracks Portland specifically and they have indicated in their Q1 2017 report that escalation in the Portland construction market was 4.58% over the course of 2016. They do indicate Portland as the US market that is at the highest peak of its construction market cycle. We believe we are seeing the impacts of that now here in first half of 2017. And again, these surveys do not track the MF sector specifically and we think there is significantly higher escalation within this sector due to the factors cited above, and the unprecedented boom in market rate MF projects under construction and planned for the Portland area.

***Questions: What indicators, if any, are there that the market softening that will get us to more competitive bids at the subcontractor level need to occur? Is there a time in the future we see this taking effect?***

***Answers:***

- Not yet, but this can't logically continue for much longer before there's no business case for the project.
- Historical experience tells us we're approaching the top of the current market cycle. While the current historically high escalation may continue for another 6 months or more we think it's

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highly unlikely to continue for more than 24 months. And then it's anyone's guess if there will be a steady tapering off, or a bigger sudden falloff caused by a major economic or financial disruption.

***Questions: Are the same cost increases (both percentage and real dollars) being felt by the private development market as well? Are you working on deals with market rate developers that are experiencing the same kind of cost increase percentages and real dollar increases? Are those projects experiencing the same levels of inflation? If not, why?***

Answers:

- Yes. Three of the projects listed above are market rate projects and variably saw increases in the same range as the affordable projects. We also had one market rate developer active in Portland tell us that his current project experienced a 14% increase in a one year period.

***Question: Can you, without naming specific projects, demonstrate the deals you are working on that have had pricing that dates to OHCS NOFA submission in 2016 and has been re-priced in the last month or so? Can you demonstrate for those projects what their overall construction inflation costs were as a percentage and dollar amount?***

Answer:

- Four of the affordable projects listed above went through the 2016 NOFA. These projects encountered various increases: 10% increase from Dec. 2016 – May 2017, 9% increase from Apr. 2016 – May 2017, 17% increase from Jul. 2016 – May 2017, and 13% increase from Apr. 2016 – May 2017.

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