

# Fuzzy math

Why the diminished residential market hasn't softened commercial construction costs **Interviewed by Paul Harvey**

**S**ometimes numbers don't add up. The San Diego housing market has been slumping, with housing starts down, residential builders closing their doors and scores of mortgage industry workers enduring layoffs. The application of basic economic principles to this scenario might suggest that commercial construction costs would be declining in the near future.

"The reality is that, while the residential market is down, there's so much commercial and municipal construction going on in San Diego County that the cost for build-outs has continued to rise," says Kirt Gilliland, senior vice president of project management and principal, Irving Hughes.

*Smart Business* recently spoke with Gilliland about San Diego's rising construction costs and how they impact commercial leasing, our cost of living and Southern California's future growth.

## How do increased construction costs affect commercial leases?

The reality is that the cost of construction materials is driven by the international demand for basic construction materials like fuel, concrete and steel. Locally, the cost of living drives the cost of wages that contractors and subcontractors have to pay, whereby San Diego is still one of the most expensive markets in the country. As we're negotiating new leases, construction costs continue to rise. Since some amount of build-out costs typically are amortized in a lease, the instinct is to want to ask for less tenant improvement money to lower lease rates, but it's not that simple.

## Why isn't the housing slowdown cooling commercial construction costs?

There's so much commercial and municipal construction going on that many of the housing subcontractors have simply been absorbed into these other environments. San Diego County's adjoining suburban markets — Vista, Escondido, San Marcos, Chula Vista and others — are going through huge growth, building retail and commercial projects. Additionally, public entities, such as city governments and redevelopment agencies throughout the county, are all undertaking large projects. In National City, there's been a proposal for a new sports facility for the Chargers, and they're considering a new billion-dollar



**Kirt Gilliland**

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convention center, so the pipeline of work doesn't have contractors concerned.

Add to all of that the work on Interstates 15 and 125, the ongoing hospital modernization projects and huge projects at nearly every college or university, and it's easy to see why the demand for builders has not diminished. If you're a pool installer, you may have seen a slowdown, but if you're in concrete, framing, drywall installation or plumbing, you don't care whether you're doing a residential or a commercial project. There's enough commercial construction out there now for workers.

## What factors are driving the increased costs?

Increased costs include higher fuel costs, rising consultant fees, public improvement fees and 'green' requirements. Fuel costs not only impact the manufacturing of materials, they ripple their way through everything. Materials, equipment and workers have to be transported, so when gas prices increase, contractors are forced to pass the increase along to the end users.

Consultant fees are also on the rise for the first time in several years. There is now such a shortage of quality architects and engineers that most firms in town are scrambling to hold on to their good people or find good people. The higher salaries used to attract and retain these workers are then passed through to the corporate

tenants and landlords hiring these firms.

Further, since government agencies have less money for public improvements, when people apply for building permits, the agencies are saying, 'Great! No problem. You can have a building permit, but you have to pay to upsize the intersection, modernize the stoplights and add a merge lane onto the freeway.' These are huge costs, and they get passed along to consumers or whoever is building the project.

## What are 'green' requirements?

It is a general term for items like energy efficient equipment, the use of renewable resources and the process by which waste is recycled. We're finding more clients that want to be somewhat green and do their part to combat global warming. These requirements add from 1 percent to 10 percent to the cost of a project, but they're willing to pay the dollars to have these things done. Some of the green add-ons do have a payback, like solar energy systems that generate electricity and reduce utility bills.

## How is San Diego's cost of living impacting construction costs?

The cost of living in San Diego continues to rise and this affects wages and, ultimately, the cost of labor to install materials and equipment. There also is a shortage of labor here in town because people don't come to San Diego for entry-level construction work. They can work someplace else and make the same kind of money without the high cost of living. In order to keep their best employees, contractors are raising their prices to retain workers.

## How will this cycle play out?

I don't see things changing any time in the near future. Some people are talking about the economy crashing, but in the last election, we approved several billion dollars worth of bonds for public improvements and construction. Just because there's a housing slowdown doesn't mean people aren't being born here and moving here. As long as our population is increasing, there is going to be a demand for construction.

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