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Commercial Real Estate

Real estate, construction industries adapt to market challenges

In IBJ's Thought Leadership Roundtable, executives at Gray Capital and Renovia discuss market headwinds, Indy's resilience and the how technology is improving everything from project management to rental rates.

Q: How have the city's commercial real estate and construction markets changed since the beginning of the year?

Spencer Gray: The commercial real estate market in Indianapolis has shown strength in 2022 despite the headwinds of higher interest rates and economic uncertainty. The biggest difference this year compared to the frenzy of 2021 is a return to somewhat more "normal" market conditions. While prices are still elevated and speculative, they are more closely aligned with fundamentals than we saw last year.

Chris Hall: The direct impact of inflation on the construction market has been sending shock waves throughout the industry. Indianapolis, like many other cities throughout the Midwest, is no exception. Sourcing challenges will continue to lessen over the remaining months of 2022 but will continue well into 2023. Suppliers will continue to get their footing, although labor woes and inflation are pesky problems that we don't see changing in the near term.

Q: How has the performance of those markets here differed from our peer cities or from broader national trends?

Chris Hall: Every city and virtually every industry is facing some sort of labor challenge. The Association of Builders and Contractors estimates that the industry will need to hire up to 650,000 workers to be able to keep pace with the increasing demand. While individually Indianapolis has performed well amongst it peer markets throughout the Midwest, this is a trend that will persist well into the future. Another critical impediment within construction has been the slow or non-existent adoption of technology. I believe this could be a very large bright spot for Indianapolis given the tech-infused landscape that's already in place, making way for various strategic partnerships.

Spencer Gray: Indianapolis is much less volatile than many other U.S. markets. In the multifamily space we are seeing strong demand and rent growth, but we are not seeing the deluge of new construction that many other markets are witnessing. The stability and value proposition of Indianapolis continues to attract more out-of-state and international investment as well.

Q: How is the ongoing labor shortage affecting your industry and how are you responding to it?

Spencer Gray: Finding the right personnel, along with qualified and available vendors, continues to be a challenge. Experienced and reliable maintenance personnel were a challenge to attract and retain prior to the pandemic, and as construction demand has picked up across the board, from single-family home development to infrastructure projects, it has become necessary to pay a premium for the right employees.

Chris Hall: The construction industry is still trying to overcome challenges associated with attracting qualified candidates. We have an aging population exiting the industry, with about 21% of construction employees 55 or older; just 9% are 24 or younger. Millennials aren't flocking to careers in construction, and a lack of diversity coupled with uncertainty surrounding immigration will only continue to make matters worse. At Renovia, we're excited about what the future holds when it comes to investing in our subcontractor workforce through professional services and industry-leading technologies. We're also using community engagement to help in talent acquisition.

Q: What other market forces are affecting your industry?

Chris Hall: According to one study by McKinsey & Co., 98% of construction projects come in over budget and 77% of them suffer significant delays. Supply chain disruption and sourcing challenges started during the pandemic but have prolonged well into 2022. Key shortages related to lumber, paints & coatings, aluminum, steel, and cement have all plagued the industry. The shortage of these materials has resulted in project delays.

Aside from the supply chain disruption, many construction companies have faced significant price increases passed down by various manufacturers. As a result, a few major retailers that we work with have been much more willing to adapt and use alternate products to fulfill their commitments. To be successful in the new economy, a business must adapt and provide valuable alternative solutions that still meet the long-term goals of the customer.

Spencer Gray: Interest rate and bond market volatility has been the most disruptive force in commercial real estate. Higher interest rates coupled with low cap rates (high prices), have limited the amount of leverage prospective buyers can utilize. This deleveraging reduces some risk in the market, while moving many buyers that have historically relied upon higher degrees of leverage to the sideline. This has led to institutional investors being even larger players in the acquisition space than before the pandemic.

Q: What policy trends are likely to shape your industry in the near-term or long-term?

Spencer Gray: With a lack of affordable housing becoming more of a hot button and kitchen table issue, we are expecting calls for rent control at the local and potentially national level, despite the evidence that suggests rent control has the unintended consequence of decreasing housing supply and raising costs over time.

Q: What, if any, bubbles do you see forming in commercial real estate here or nationally?

Chris Hall: Conditions are primed for what many would call a bubble forming in commercial real estate given the rise in prices to unsustainable levels. We're going to continue to see long-term residual affects of inflation riddled throughout the market both locally and on a national scale. Couple that with higher interest rates, ongoing war in Europe with no end in sight, and a Presidential Election in 2024, and it's hard to predict where the market is headed. This produces a more risky investment market for all.

Spencer Gray: While I do not see any concrete evidence of a bubble today in the commercial real estate market, the ingredients for a potential bubble are certainly present. If commercial real estate investors speculate that inflation will remain significantly elevated for an extended period of time but instead growth slows dramatically, we would expect a much-needed price correction.

Q: What is the outlook for the office market in the next 12 to 24 months?

Chris Hall: The cost of capital has played a direct role in the slowdown in transactions that is taking place in the back half of 2022. Think of it this way, over the course of the last 10 years we've enjoyed a multitude of economic factors that have been beneficial to owners and investors alike. But now the market has shifted from a dead sprint to that of a marathon. I have no doubt that as the market landscape shifts and conditions change, so too will the ways investors and owners enter and exit the market.

Q: What about the housing market?

Chris Hall: Simply put, we haven't built enough multifamily housing to accommodate the significant population increase that we've experienced over the last decade. Gen Z is helping to drive this demand, although many Boomers are taking advantage of the hot real estate market to sell their homes. The trend toward workforce housing is likely to persist, thus increasing demand for flexible, convenient housing vs. the liability or hassle associated with owning your own home. Outside of Indianapolis, many markets have a limited housing supply, but new starts remain consistent. This has brought positivity to what some folks might be labeling as a "big slowdown looming." We're still seeing buyers of multifamily projects enter the market, but before COVID you might have seen as many as 24 buyers arrive at the table. Now we're seeing half that number, if not fewer, as the market has tightened.

Spencer Gray: The multifmaily housing market is currently benefitting from lack of affordability of single family homes due to higher interest rates, which leads to a much larger monthly payment. Renting an apartment is now five times more affordable than buying a house compared to where we were in 2019. Many millennials who were in the market to purchase their first home can no longer qualify and are putting off the prospect of owning for the foreseeable future. The high barrier to buying is not only driving rents in the B and A class space, but has created low vacancy levels. Simultaneously, we are seeing weakness in market rate workforce housing, as inflationary pressures such as gas and food costs place a ceiling on rent growth for lower income renters. Rates of eviction and delinquency are also elevated in this demographic, although still lower than pre-pandemic levels.

Q: How are emerging technologies changing your industry?

Spencer Gray: The continued adoption of automated revenue management software that uses algorithms and daily market inputs to set new apartment rents on a daily basis based upon current market pricing and availability has greatly changed the apartment market in recent years. While the technology has been around for some time, it is now being used widely across the multifamily industry. The result is a much more efficient market as well as rents that range widely depending on the day a prospective tenant tours a property. In the past, property managers would use their sense of the market to set rents, usually on a yearly or quarterly basis. The use of this technology has certainly been a factor in rents growing four times what we would see in a typical year.

Chris Hall: The industry at large has been slow to adopt technologies that could equip and connect multiple distribution points along the value chain. Companies are now looking at multiple SaaS-based platforms that can connect people, processes, and assets to allow for a more digitally enhanced insight into daily operations. What we're now seeing is small-to-medium sized companies looking for a platform that can connect their portfolios, creating a more manageable seamless process related to capital expenditures, facilities maintenance, and tenant improvement projects. Continuing to invest in data, analytics, and user-based experiences are must-haves if you're looking to innovate in the future.

Data collection apps, drones and Artificial Intelligence are all starting to become the norm in construction as tablets and smartphones make for better connectivity and communication from jobsite to jobsite. Aside from the benefits delivered to customers, companies are gathering more accurate and higher quality data to provide a real-time picture of changing costs and project timeframes to deliver to the client. Drones are more and more prevalent in today's world given the accuracy and interactive data they can collect while on a jobsite. This is especially critical for budget-constrained projects where access is difficult and accurately projecting costs is a challenge. Meanwhile, the use of Artificial Intelligence has significantly helped our business create forecasting metrics and cash projections that are helping fuel growth.

As President of Gray Capital, **Spencer Gray** focuses on investment strategy and driving forward the vision of Gray Capital, a multifamily real estate investment firm. Since founding Gray Capital, Spencer has been involved in more than $1.5 billion in transactions. Gray Capital controls over $600M of multifamily real estate across the Midwest.

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Chris Hall is the Vice President of Sales at Renovia. He's been with the company for over 11 years, during which time he has held various roles within the Sales Department. In his current role, he oversees sales and marketing for Renovia's five branch offices and its National Accounts Team and helps spearhead new business and client opportunities. He's played an integral role in the company's expansion in the last 24 months into the Dallas, Baltimore/Washington, D.C., and Myrtle Beach markets.

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