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Rising costs, interest rates add caution to optimistic development picture

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In spite of Boston's unprecedented building boom, many developers and investors may be feeling a little uneasy right now.

With $4 billion in approved projects already in the pipeline, the cranes will be busy in Boston all summer long. But the rising cost of materials and the potential of rising interest rates are a double threat for developers and investors.

Even as the price of lumber has plummeted, the price of steel, cement and other materials used in commercial building has been rising, which could affect profit margins.

The potential of rising interest rates is even more worrisome, though. Rates have already increased somewhat, but the cost of money is still so cheap, it's not slowing development down. The bigger concern is where rates will be three or four years from now, when many developers have completed construction and are seeking permanent financing.

Rates will likely be higher than they are now, but no one knows how much higher.

Because of these twin threats, developers who have not yet begun construction should review their plans closely, and project their costs and profitability under various interest-rate scenarios.

Many will, and should, reassess the financial structure of their projects and reduce the risk of higher rates by increasing the equity portion of their financing. Instead of equity financing accounting for 25% of a project, it may, for example, make sense to increase the equity stake to 35%.

Investors will, of course, also be affected if interest rates increase, but they have an automatic hedge. If rates increase, so will inflation, which will increase the value of the buildings in which they've invested.

In addition, those developers who are able to will undoubtedly seek to lock in tenants with leases and lock in financing, so they can increase their security as their projects move forward.

That's not always possible, of course, so in some circumstances projects may end up being delayed, scaled back or even shelved.

It's partially a matter of timing. Real estate cycles can be fickle and unpredictable. While Boston's permitting process has been proceeding quickly, some developers may find that their project is out of cycle by the time they're ready to build. In such cases, developers may defer development and carry the project for a couple of years or so.

That is not to say that the Boston market is in trouble. It's still the most vital commercial real estate market in the country right now. There are so many projects ready to begin construction, the market will remain busy even if some projects are delayed.

Economy Improving

Ironically, any slowdown in real estate development will likely be the result of an improving economy.

Interest rates have been pushed to historically low numbers by the Federal Reserve Board's quantitative easing program, but after purchasing nearly $3 trillion in bonds, the Fed has signaled that it may begin to ease its purchases if the economy continues to improve.

If quantitative easing slows down, interest rates will rise, which will cause development costs to increase.

And it is increasingly clear that the economy is improving. The unemployment rate is still well above the Fed's 6.5% target rate, but it has been trending down and is now at 7.5%, according to the U.S. Bureau of Labor Statistics. That's down from a high of 10% in October 2009.

Housing has, of course, also improved significantly. The average price for a house in Massachusetts increased 6.7% in the past year. That's much less than the 15% increase the rest of the country experienced, but that's because housing prices didn't drop as much in Massachusetts when the housing bubble burst as they dropped in other parts of the country.

The pace at which sales are taking place is one indicator of market improvement. The selling period for homes in many cases is down to days instead of months and bids are coming in above the asking price.

The Conference Board's Consumer Confidence Index has been climbing and reached a five-year high in May at 76.2, up from 69.0 in April. The index measures consumers' assessment of economic prospects on a scale of 1 to 100.

Given all of this positive economic news, pressure is coming off the Fed to maintain liquidity, which means were getting closer to the end of quantitative easing - and closer to the end of low interest rates.

An improving economy is always good news, but developers will need to brace themselves for the consequences of higher interest rates.

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