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report

Construction Costs Out of Control, Says Ebert

Alan Kohler speaks with Warren Ebert, the chief executive officer of Sentinel Property Group, about the rising cost of construction, industrial property, and the impact working from home is having on the office market.

By Alan Kohler · 17 Oct 2023

Alan Kohler here and I'm talking to Warren Ebert, the CEO and Founder of Sentinel Property Group – and it's always good to talk to Warren about property because he knows what he's talking about. In this interview we cover industrial, that is, warehousing, office and retail, and an important part of the reason for talking to Warren is because he's got some interesting things to say about construction costs and what's happened over the last few years, because he's got some personal experience there. But it's also interesting to hear him talking about working from home and the effect on the office market and also, online shopping and what's going on with retail.

So, here he is, Warren Ebert of Sentinel Property Group.

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Warren Ebert - Sentinel Property Group

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Warren, you've been telling me that you've got a good read on construction costs because you've built some sheds over the past few years and you've been able to see firsthand what's happened to construction costs, tell us what you've seen.

Alan, we're certainly not in the high-rise, like Tim Gurner and some of these other fellows, so I'm not professing to be an expert on that, but as I said to you a couple of weeks ago, we've done a number of industrial sheds up at Paget in Mackay, which is a main industrial precinct…

By sheds, you mean warehouses, do you?

Sorry, warehouses. So, they're 2,000 metres floor area, 250 metres of office, they're 15 metres high, 12 metres under hook which means you can have a crane that the bottom of the crane comes to 12 metres. Now, they've all been identical. Four years ago, it was $2.4 million, we've now received quotes about a month ago from three separate builders and it's $6 million, so we're up 2.5 times, that's no increase in land, that's just construction and I think you can't get anymore basic than an industrial shed/warehouse. It's concrete and steel, you don't have other fit out, there's not an enormous amount of electrical and plumbing, so it's pretty basic, but that just shows the increases in prices and tenants certainly can't pay more than double the rent and that is translating into offices, units – a friend of mine in Brisbane who will complete the best part of 400 units in Brisbane by Christmas, he said, "When they're finished, he's not building anymore in the foreseeable future, the numbers just don't work."

We've looked at doing some retail warehouse product for the Harvey Norman type large format and even if you get the land for nothing, you cannot make the deals work, construction prices are just completely out of control.

So, are you going to build the shed at $6 million dollars?

No, no, it just can't work. We would have to get well over $300 dollars a square metre from an industrial tenant, where four years ago it was $120 dollars a metre. I don't know what's going to give, but certainly for industrial funds that have got some older sheds, there's some enormous rental growth and that's what you're going to see – well, you've already seen it now and that'll go on for the next few years, but it's getting almost impossible to build new ones. We're seeing it with office in Brisbane. We've got a couple under construction, when they're finished, there can be no more. Projects, residential and that are getting shelved everywhere.

Well, it's interesting, because I presume that the increase in price that you've experienced over the last four years, that isn't just going onto builders' margins, right? I don't know whether their margins have expanded, do you know whether the margins have expanded or whether it's all just on material costs?

Alan, the number of builders we've seen go broke, their margins certainly aren't expanding. They're trying to, you know, the big builders and you look at the public records and builders like Hutchisons, they've published their results and their profit is a couple of per cent, so they're certainly not making big margins. Where they can, some were trying to do some clawback, a lot of them pro-builds, some multi-billion dollar companies have gone down because they had fixed price contracts and they've just lost hundreds of millions of dollars, if not billions. So, certainly builders have not been increasing margins…

So, who's doing the gouging?

Well, a lot of it is in your product, your steel prices, concrete, all the materials, but certainly wages have just gone through the roof. We've just seen here in Brisbane overnight, the union's doing the Cross-River Tunnel, the workers are on $250,000 and they want a 20 per cent pay rise, which is going to get them up over $300,000. While Tim Gurner got into a lot of trouble for the things that he said, maybe it was the way he said it, but we're finding wages are through the roof and productivity isn't there. They just aren't putting in the hours and there's a lot of days off and I don't want to get offside with the unions because we still have to get work done, but I think if people analyse it, that's the facts. When you get big developers saying, "We just can't do anymore…" they make their money out of doing developments, they don't want to stop building but they just have no choice at the moment, the more they build, the more money they lose, Alan. It's a critical situation and we've got terrible housing prices across Australia and it's only getting worse, it's not getting better.

And you reckon it's wages?

Wages, productivity and materials, but I understand that materials have started to – inflation in that has started to ease off, but the wages are just through the roof. No matter what I say, there'll be unions and Government who'll say, "That's just not the case," but I've seen plenty of examples and there's a project over South Brisbane just recently where there was a picket for a few weeks and wouldn't let the crane in. Now, I don't want to say who was doing the picket because I'll get into trouble, but until that builder appointed a builder that uses EBA, he couldn't start the project.

I think you are in trouble, Warren.

[Laughs] Probably, but some people have got to speak out about it, Alan, it really is out of control.

Right, well it's certainly not showing up in the statistics yet. Maybe you and the people you're talking about are the canaries in the coal mine.

I think they are, we're at the pointy end and we deal with your larger large-format, your Supercheap, your BCF, your Spotlight… You speak to all those fellows and the projects have just stopped, they're not building anymore. The rents that we have to get to make a project viable, the tenants just can't pay it, so yes, I think we are the canary in the coal mine, but when you – so, this friend of mine who'll finish 400 units in the next few months, he would do that 500-1,000 every year, he's just not building anymore for the foreseeable future. It is getting worse. Then we have the Olympics coming up here and while it's still a fair way away, nine years, the amount of work that is coming up for some of these Government supported projects, some of these unions just say, "Well, we don't care about you, we've got plenty of Government work." And that's a fact, Alan.

So, your experiences in warehouses, what you're saying, the same thing is going on everywhere, is it?

It is, yes, absolutely everywhere.

Because there has been obviously a boom in warehouses, you don't think it's possible to get the rents in warehouses that you need?

Not now. We certainly had a massive boom and you've seen substantial rental growth, you know, sheds at big warehouses around Eagle Farm, Pinkenba, The Port of Brisbane that, say, four years ago might have been $90 to $110 dollars a square metre rent, they're now $150 to $200 dollar a square metre. That's the sheds that are finished now, if you were to start another one now they're up possibly another 30 per cent.

Right.

So it's just really getting out of control and given where the market has gone, your capitalisation rate that you sell these on has blown out, so you've got a double edged sword, you've got the cost of building them has gone up and the price you can get for them on an end sale has come down.

What's happening to office rents?

We're seeing what you call face rents, in Brisbane, which is on the lease, they're going up.

What's face rent?

What they do, your lease might be, let's say, $1,000 dollars a square metre, but then you'll get maybe 40 per cent incentive. Now, that can be taken as, they can do your office fit out or reduction in rents. So, if you have an existing fit out, you do a lease at $1,000 dollars a square metre with a 40 per cent incentive, so your effective rent is actually $600 dollars a square metre.

But for how long, is that for one of the years or something?

No, it'll be for the length of the lease.

Right.

It's what we call 'smokes and mirrors', Alan, it's been going on for years and that's why you're seeing the problems in office at the moment. They buy an office building at 5 per cent, you have 40 per cent incentive, so your net effective return is about 2 per cent. That's why you're seeing the office market coming off and it has to come off more. It's been smokes and mirrors for years, Alan, and there's now just a bit of catch up.

Are you inclined to buy any offices yet?

Alan, funny you say that, there's one in suburban Melbourne, Richmond, that we agreed to buy a couple of weeks ago. 30th of June '22, that was valued at $132 million; 30th of June '23, it was $110 million, and we're at $80 million.

And what, you're going to get it for $80 million?

We have, yeah, we've picked it up for $80 million.

And what's the yield on that?

That'll be 9.3.

9.3 yield? Crikey.

Yeah. Alan, I think when I first spoke to you, it would have been that 2011/2012 when we bought our first one in Melbourne, which was actually 385 Bourke Street, I think we're back to those times, I think next year there's going to be some fantastic buying in the office area. The big buyers over the last few years have been your KKR, your Brookfield, your Dexus, JP Morgan... None of those are buying, they're all selling, so if you have no buyers and all sellers, what does that do to any market?

What's your view about working from home going forward? Do you think that the companies are going to pull everyone back into the office?

Yes, without a doubt and the companies that don't will just get further behind, Alan. There was an article in The Fin Review a few weeks ago, I think ANZ have 20,000 staff or something, there was quite a number who were told they could work from home by their management, so they can't change that but apparently they're down to about six staff, they don't know where they live, whether in Australia or overseas and they were told they could work from home so they can't change that. But people who don't come into the office, Alan, just get further behind. If you're going to learn, you need to learn off others. I think CBA said all their senior management must come into the office five days a week and they're trying to encourage as many people back to work as possible and it will happen. I see, reading an article in Tokyo, they're all back to work now. If your company is going to progress, you have to be collaboration, you've got to talk to each other.

Now, there'll be some, I think, like Governments, they can continue to work from home because when they're at the office they don't do anything so I think they can maintain that productivity by working from home.

[Laughs] I think the assumption's been that we'll settle into a system where people work in the office for three or so days a week and work from home two days a week, you don't think that's going to happen?

I don't agree with that. A friend of mine who's got a very big accountancy practice and he has about 1,100 staff. Now, a lot of those were working from home before because they do data entry and the work people that he has, a lot of mothers who have children and they can take them to school, do their days' work, pick them up and it works very well, but that's a very small percentage of the workforce. Particularly if you're a young person, you're wanting to advance, how do you learn if you don't mix with more experienced people, Alan. I think it doesn't matter what business you're in. That's my view.

But that's motivating you to buy offices next year and now, in fact?

Very, very selectively. The one we bought is in the fringe, because what we're seeing is it's got an enormous amount of car parks, it's close to the MCG, close to the freeway, so even for people who are working from home and if they come in a few days a week, quite often they then need car parks, so you've got to be selective with what you buy. I think Melbourne has got a bigger problem, from what I understand, as far as people working from home than what other places do. Brisbane, because we never had COVID as bad, we just didn't get as many people into the habit of working from home, certainly the Government people did and that's harder getting them back to the office, but most of Brisbane is pretty much back. Commercial people are back.

So, will you open a fund for this Richmond office for $80 million?

Yeah, we've started to go out to people now. One of the buildings is four years old, Alan, but that's what we're seeing – and don't forget, at $132 million, let's just say you had a 40 per cent loan to value ratio, well that's a debt of $52 million. Now, when you get back to a sale price of $80 million, you still have $52 million dollars' worth of debt, so you've got $28 million in equity, where before you had $80 million in equity.

Are you still borrowing against $132 million of value?

No, no, no, I'm saying the group we're buying it off, that's the debt that they would have had. No, we'll borrow at $80 million. We're getting back to 2012, it'll be an absolute fantastic year to buy next year, but the companies that were buying assets in the 3 and 4 per cents, that was never going to last, it was just ridiculous. You've got cost of debt at 6.6. People are always critical of us because we had high loan to value ratios, but we're buying things in the 7 and 8 per cents. You know, we were never buying in that 4 per cents and those people who are buying in those yields, Alan, and if you look at some of the REITs, you can look at their reports, they've still got average yields in the 5 per cents.

And you're buying at 9 to 10 per cent now?

Yes.

Do you reckon you can keep doing that next year?

For sure, without a doubt. There's very, very few buyers around at the moment, Alan, and what we're seeing because of the nervousness in the market, we've seen a few funds who are out buying assets and they haven't been able to raise the equity, so there are very few buyers and what you find is as the pressure amounts on these people, receivers normally don't market things in the run up to Christmas. I think by March next year, we're going to see a lot of assets on the market, an enormous amount of assets with very few buyers.

So, what are warehouses yielding at the moment?

There's a big discrepancy there, Alan, and there's an asset up here, fantastic asset, 15-year lease to an absolute sensational company. Now, two years ago, that would have sold at probably 3.25 per cent yield. The problem with that is that it has fixed reviews at 2.75. Now, when you had inflation at zero, that was good rental growth. Now we've got inflation at 7 per cent, even coming back to 6 or 5, that property is unsaleable. So, something that is worth a quarter of a billion dollars and they would have fought over it, now they can't sell it. But if you have an old shed that has got a tenant in there at $90 bucks a metre and to build a brand new one it's going to cost you $180, well someone might buy that at 5.5 per cent knowing that in 12 months' time they can lift their rent by 50 per cent, so it depends on what the shed is, but a couple of years ago, the new sheds, long lease, 10-15 year leases, fixed reviews of 2 per cent, they were going sub 4 per cent yield. Now, you can't give them away.

So, it depends on the sector. These funds that have had ordinary old sheds, that's where the money is. You know, as they say, there's money in manure, Alan, or whatever name you want to call it.

[Laughs]

So, some fantastic opportunities, but to replace sheds or to replace anything, offices, shops… We bought a shopping centre up in Mackay not long before Christmas for $280 million, replacement cost is $700 million.

That's incredible.

It is, but that's what is around. When you get into these difficult times or challenging times, you find most people retreat to their home markets.

Let's talk about retail, what's your view now about online retail versus bricks and mortar? Because, obviously, online went up a lot during the pandemic, but it's come back down, what do you think the future is there?

The future for bricks and mortar, if you use Myer as an example, Alan, and I think they did it pretty tough for a long time, I can't remember the exact numbers, but they brought down their profit a month or two ago and while their profit was up something like 15 per cent, their online was down 20 per cent. So what we're seeing, is people are going back to the bricks and mortar and during COVID, people had to buy online – no wonder it'd been – they had to buy online because they couldn't go to the damn shops. We are now seeing that people, to go and have a coffee, their social areas and where most of our properties in the north, if you use somewhere like Darwin for example, when it's 35 degrees and 90 per cent humidity, you don't go for a jog, you don't go and play golf, you go to a shopping centre.

You're finding a lot of the shopping centres, they're really catering for people to stay there longer, have a coffee, do a little bit of shopping. So, online will never go away, but even for myself, Alan, if I want to buy something from Supercheap, what I'll do is have a look online, have they got it? Then I'll go and pick it up. Most of us are in the age of instant gratification, if I wanted something in a week, I'd order it next week. I want something today, so I go and pick it up. Bricks and mortar is going very strongly, online – the facts are there that it's come off. You see Amazon, their first last-mile warehouse in Brooklyn, they closed that some months ago, they've cut back on a lot of staff. There's always a market there, but the boom has stopped. Our CFO here during COVID, he went and picked something up for his son from Kmart, got it home, it was the wrong colour and wrong size, he said, "That's it, never again, I'm not doing it."

When you go and try it on, you get exactly what you want. So, it was an experiment then a lot of people tried, but a lot of old people – and a lot of the online companies, Alan, are actually losing money. The younger people will order four or five pairs of shoes and half a dozen shirts, they'll pick the one they want and send the rest back because it's a free return. A lot of those online companies weren't making money, we've seen a number of them close up, so that's why we're a buyer of retail, I was a believer that it couldn't keep going and it hasn't.

You're still buying retail?

For sure, yeah.

What are you paying, what sort of yield are you paying?

Well, we were buying in the mid-7s, sort of getting close to 8 per cent fully leased, but also the last couple of centres we bought in Darwin and Mackay – the one we bought in Darwin, Alan, every man, woman and child in Darwin goes to that shopping centre 5.1 times a month. There would not be another shopping centre in Australia that dominates that market… So, if you buy those type of things, they're bullet proof. If you're to build a Westfield type shopping centre, you would get a Myer, a David Jones, a couple of department stores, a couple of supermarkets and a couple other specialties. But now, the department stores, they're not building anymore department stores, so the finances just don't work to build these big centres, so if you have a good one – and that's where you see Westfield selling their smaller ones and keeping their major ones, up in Queensland you've got the likes of Chermside which are a city, it's a great time to own quality shopping centres. Speaking to a friend of mine who's one of the leading shopping centre sales agents in Australia, in the western suburbs of Sydney, where the new residential boom, where they have the big mortgages, those shopping centres are in trouble because those people just don't have much money to spend. But in the more older established areas, and I think you've had charts in Eureka Report – which is the best read of the week for anyone who doesn't get it – the older demographic are spending more money. It's a great time to own quality shopping centres in the right locations, you've just got to be selective, Alan.

But it sounds like, with all of this stuff, a big factor now is replacement cost?

Exactly, and as I say, ours in Mackay, $700 million to replace it and you can't replace it in the city, you can't get the land – and next year will be a fantastic time to buy, Alan. Never been easier, making money.

[Laughs] Well, that's good to hear.

Yeah.

As always, great to talk to you, Warren, thanks.

Terrific, Alan, look forward to catching up soon. Thank you.

That was Warren Ebert of Sentinel Property Group.