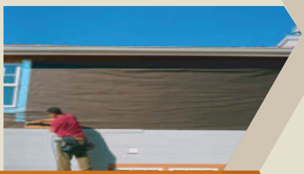


Industry Sector Report

Construction Industry Insider

2015
SONOMA COUNTY

SONOMA COUNTY
EDB
ECONOMIC DEVELOPMENT BOARD

Sonoma County
Workforce Investment Board

2015 Construction Industry Insider

2015

The Sonoma County Economic Development Board (EDB), in partnership with the Sonoma County Workforce Investment Board, is pleased to present the 2015 Construction Industry Insider for Sonoma County. Our research partner, Moody's Analytics, provided the research for this report.

Highlights of the 2015 Construction Industry Insider include:

- Sonoma County is slowly rebounding from an earlier softening and is now closely tracking the national pace. The real estate market experienced a slight downshift in 2014. Although house price appreciation advanced at a steady clip, sales of existing homes slowed substantially.

- Construction activity in Sonoma County picked up pace in 2014, though the recovery is still slow by historical standards. As in the previous year, multifamily permitting was the primary driver of construction, although single-family homebuilding began to gather steam in late 2014 and early 2015.

- Prices will increase for commercial and residential real estate in 2015, though for different reasons. Demand for new homes will pick up as income growth accelerates, household formation picks up, and the low single-family house inventory attracts investors in new construction.

- Despite favorable in-migration, Sonoma County will mirror the general national demographic outlook, and its population will gray over time as the retiree population grows in comparison with households in their prime earning years.

Thank you for your interest in the Economic Development Board's research. For additional information, questions, comments, or suggestions please contact us at (707) 565-7170 or visit www.sonomaedb.org.

Sincerely,

Pamela Chanter
Chair
Economic Development Board

Ben Stone
Executive Director
Economic Development Board

Recent Performance

Sonoma County is slowly rebounding from an earlier softening and is now closely tracking the national pace. Overall payroll employment gains are still above average, and the pace of hiring is robust. The unemployment rate has fallen even as more workers returned to the labor force. The jobless rate reached 4.9% in December, well below average and the lowest since early 2008. A stronger job market has yet to lift income growth, but recent gains have helped strengthen consumer credit.

Sonoma County's real estate market experienced a slight downshift in 2014. Although house price appreciation advanced at a steady clip, sales of existing homes slowed substantially. According to the California Association of Realtors, median house prices have recovered nearly 70% of their peak-to-trough loss, well ahead of the statewide average of 57%. While price appreciation has slowed at the national level, a shrinking inventory of existing homes has kept prices high, reducing affordability and preventing pent-up demand from being unleashed. Although stronger in the last two years than in any period after the recession, issuance of construction permits remains well below the prerecession peak. Multifamily units continued to be the primary driver of residential construction, while commercial real estate construction picked up for the first time in a decade.

Macro Drivers

After a weak first quarter, the U.S. economy bounced back over the course of 2014, pushing growth north of the 2013 rate. Perhaps the most significant development of the year was the rapid decline in joblessness, bringing the U.S. economy closer to full employment. Household balance sheets grew healthier and businesses remained highly profitable. Fading fiscal drag from prior federal spending cuts was also a positive, but a disappointing housing market recovery—stemming from weak household formation—has created some friction. Lackluster growth in emerging markets has been another impediment to a stronger recovery. Nonetheless, all ingredients are in place for stronger growth in 2015. Moody's Analytics forecasts real GDP growth of 3.7% this year. A better economic environment should also boost wage growth and help the U.S. economy achieve full employment by mid-2016.

The sudden decline in oil prices has had a measurable impact on the economy. Although lower oil prices may cause some U.S. oil producers to curtail their production levels this year, cheaper energy is helping both energy-intensive industries and consumers, resulting in a net positive for the economy. With both the drag from federal spending cuts fading and the end to the Federal Reserve's quantitative easing, the economy is taking advantage of low interest rates and growth is shifting into high gear.

The labor market is clearly in a better place than a year ago. Monthly job creation has averaged more than 280,000 in the past six months and has helped bring the U.S. unemployment rate down to 5.5% in February.

Household formation has fallen short of expectations, slowing the housing market's recovery. As millennials start forming households at a faster clip, the housing market will grow stronger and support overall growth. However, a gradual rise in long-term interest rates will be the key to keeping the housing recovery on track. Policymakers have gained valuable experience in communicating with financial markets. Yet the process of normalizing monetary policy may not be as graceful as hoped and continues to be a significant risk.

Construction is Picking Up Pace

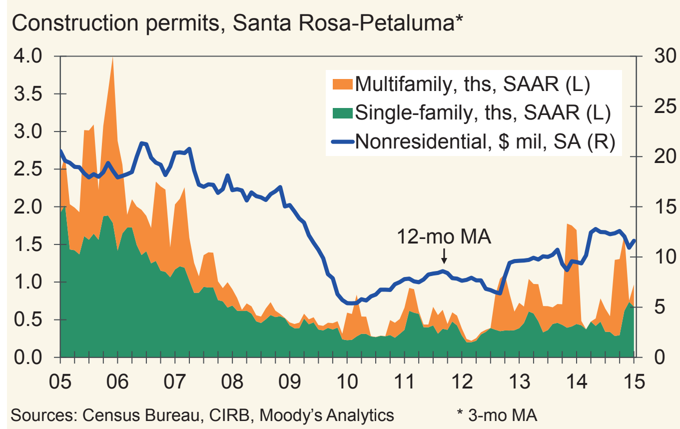


Chart: *Construction has been stronger over the past year than any year since the recession. However, activity is far below prerecession levels, and growth is moving at a crawl. Multifamily units have led residential growth, but the pace of single-family permitting is picking up steam and will return to its prerecession level in 2018. The fundamentals suggest new homebuilding should be higher, as inventories are low and price appreciation is steady. However, household formation and income gains are underperforming expectations. Nonresidential permit values are improving but have made up hardly half the ground lost during the recession.*

Industry Drivers

Construction activity in Sonoma County picked up pace in 2014, though the recovery is still slow by historical standards. As in the previous year, multifamily permitting was the primary driver of construction, although single-family homebuilding began to gather steam in late 2014 and early 2015. The long-dormant commercial market finally showed signs of life, with the nonresidential dollar volume of permits reaching its highest level since mid-2009.

Strong income growth in 2015 will be the key to unlocking pent-up demand for singlefamily homes. The housing inventory, in terms of months of sales, is just over half of what is considered a balanced market. Low inventories of existing homes for sale have kept prices for single-family homes high, while sluggish income growth has restrained sales. As the labor market tightens, income growth will begin to catch up with house price appreciation, providing a much-needed boost to single-family construction.

Though home sales weakened in the past year, the mix is more favorable. The share of distressed properties in total sales has declined markedly, reflecting improving household balance sheets and a thinning pipeline of foreclosed homes coming on to the market. Delinquency rates for auto, bank and credit card loans have fallen to prerecession levels, according to credit report agency Equifax, while mortgage delinquency rates in Sonoma are closing in on their prerecession average. While distress sales have fallen as a share of total sales, existing sales have risen to a similar share of total sales from the early 2000s. Though a sign of progress, falling inventories of existing homes are driving down affordability and keeping a lid on demand for new homebuilding.

Meanwhile, with vacancy rates near historic lows, the commercial real estate market is finally contributing to the construction recovery. According to Keegan & Coppin, vacancy rates for office, industrial and retail space have fallen to their lowest point since 2007, helping to spur new construction. Sonoma County will welcome several new office buildings in 2015, including the Museum on the Square complex in downtown Santa Rosa. Vacancy rates have fallen the furthest for industrial and retail space, where construction has proceeded the fastest, although the office market also made substantial progress. The vacancy rate for office space fell below the critical 20% mark in the second quarter of 2014, indicating that demand for new office space is beginning to outpace supply. The pace of new construction for retail, office and industrial space reflects recent employment gains. While retail payrolls have surpassed their prerecession peak, and warehousing jobs have recouped half of their prerecession peak, manufacturing and office-using employment is rising at a slower pace.

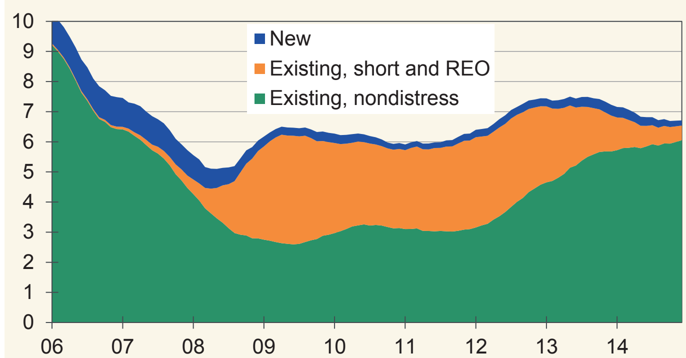
Short-term pricing

Prices will increase for commercial and residential real estate in 2015, though for different reasons. Demand for new homes will pick up as income growth accelerates, household formation picks up, and the low single-family house inventory attracts investors in new construction. However, the retirement cohort will increase proportionately in the next five years, and demand will shift slightly away from single-family homes toward smaller homes. Single-family permits lag multifamily permits, and therefore single-family prices will pick up in the near term as new homebuilding will take time to meet demand.

While commercial real estate property prices will resume their upward climb in 2015, gains will not be uniform. According to Real Capital Analytics, apartment prices rose the fastest through 2014, though prices retreated in the fourth quarter. While apartment prices will return to growth in 2015, Sonoma's large pipeline of multifamily units will slow price appreciation. Retail prices rose substantially in 2014 and will outpace office and industrial prices over the coming year, although falling vacancy rates will provide some lift for industrial and office space.

Sales Mix Hints at a Tightening Market

Home sales for Santa Rosa-Petaluma, ths, 12-mo MA



Sources: CoreLogic, Moody's Analytics

Chart: *Home sales in Sonoma County slowed in 2014, mainly due to a lack of inventory on the market. Inventories of new and existing homes for sale have fallen, putting upward pressure on prices. While a shrinking share of distress sales has helped house prices recover, faster price appreciation has reduced affordability, keeping many would-be homebuyers out of the market. Slower house price appreciation and faster income growth will help reignite sales in 2015, providing a much-needed boost to residential construction.*

Supply-side concerns

While not included in the baseline forecast, input costs for labor and materials pose a significant downside risk. After a three-year slump, lumber, steel and cement prices rose by more than twice the national rate of inflation through 2014, although price appreciation cooled in the final months of the year. County-level data on raw materials are not available, but the Engineering News Record building cost index for neighboring San Francisco has increased on par with the national average over the past three years, suggesting that labor and materials prices in the Bay Area are rising in step with those in the U.S.

Rising costs are most evident in residential construction. The price deflator for residential construction rose by nearly 6% on a year-ago basis, the fastest pace since the start of the housing boom in 2005, although nonresidential construction costs remained flat. Lower oil prices will provide some relief for homebuilders, as diesel is the primary fuel for construction machinery. However, lower energy prices will not be enough to offset the impact of rising labor costs. Although construction payrolls in Sonoma County have recouped less than half of their prerecession peak, wages are rising rapidly. Real construction wages in Sonoma County increased at nearly double the county average in 2013, the last year for which data are available. Rapid wage growth along with a falling ratio of housing starts to permits, a sign that homebuilding is lagging demand, supports anecdotal evidence of a shortage of construction workers. Labor costs will rise further as residential construction accelerates.

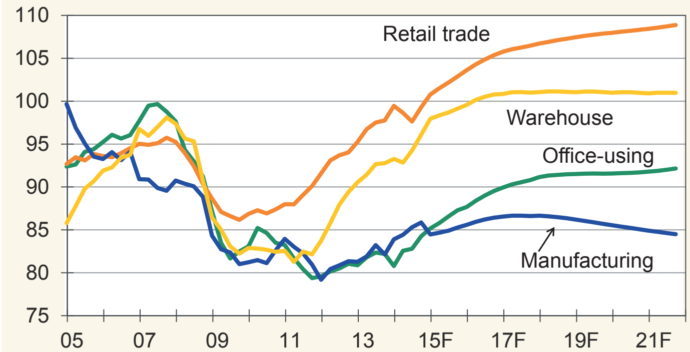
Returns

Slower house price appreciation and higher input costs will put pressure on residential homebuilding in 2015. However, more modest price gains will bolster sales among first-time homebuyers, particularly as income growth accelerates. This will provide a buffer for profits. Return on investment in commercial real estate in the West census region has moved little since returning to its prerecession average in 2011, according to data from the National Council of Real Estate Fiduciaries.

Still, Sonoma County's proximity to San Francisco and lower business costs make it a regional exception. According to Real Capital Analytics, office rents per square foot in Sonoma County are less than half the price of the supply-constrained San Francisco market. While lower rents are unlikely to attract larger tech firms, they will make Sonoma more attractive for small and medium-sized firms in the Bay Area, presenting an opportunity for commercial developers. There are some signs that this is starting to happen: Office and industrial rents have grown at a higher rate than in San Francisco in four of the last five quarters, while net in-migration from San Francisco has accelerated.

Employment Gains Drive Recovery in CRE

Employment, % of prerecession peak



Sources: BLS, Moody's Analytics

Chart: *Sonoma's rebound has driven vacancy rates for commercial real estate to historic lows, spurring a recovery in the industry. CRE development has been most robust in retail, where payrolls were the first to regain their prerecession peak. While construction of industrial space will proceed more slowly, demand will be driven by manufacturing and office-using equipment, which includes engineering and life sciences research. Development of new office space will be the weakest, due in part to greater competition from Marin County, although Sonoma will welcome several new office buildings in 2015.*

Long-term Outlook

Despite favorable in-migration, Sonoma County will mirror the general national demographic outlook, and its population will gray over time as the retiree population grows in comparison with households in their prime earning years. This will make a return to the 2005 boom in singlefamily construction extremely unlikely. Total residential construction will grow at a more moderate pace than the pre-2003 average, with multifamily and attached single-family construction doing more of the heavy lifting.

Meanwhile, after years of underperforming the residential market, the outlook for commercial real estate is much improved. However, keeping up with the sudden rise in business investment will prove a challenge, as a lack of available space has led some firms to locate new production and distribution centers outside of the county. Although retail construction will proceed at a faster pace, the completion of a new shopping mall in 2015 and the redevelopment of downtown Rohnert Park will be sufficient to accommodate the county's tight retail market.

Upside Risks

A longer than expected period of low interest rates is a significant upside risk for construction. Housing affordability is an issue, thus low rates may help sway potential buyers. Mortgage rates are close to record lows and are set to fall further as the Federal Housing Administration cuts insurance premiums. This should provide more incentives for cautious first-time homebuyers to enter the market. Fannie Mae and Freddie Mac have also made regulatory changes to encourage more mortgage lending, which will boost housing demand and help spur stronger construction activity.

The recent growth in the logging industry has set the stage for the local development of upstream industries such as processing and paper mills. Further, a more competitive commercial-space market in the Bay Area might spill over to Sonoma County, further boosting prospects for construction.

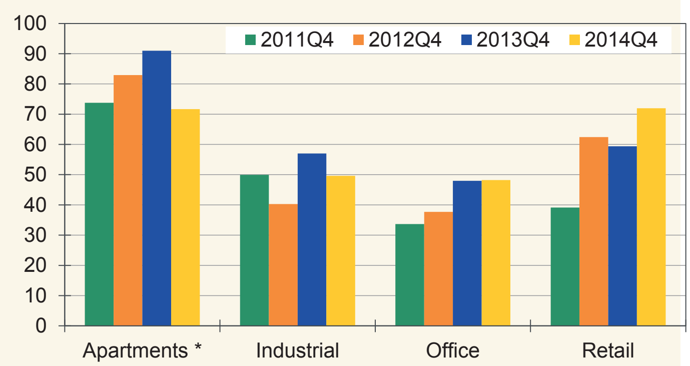
Downside Risks

A stronger than expected U.S. dollar could prove damaging to the area's economy. The first channel through which a stronger dollar would hurt growth is a rise in wine imports from Australia, Argentina, Chile and Europe, putting downward pressure on California wine sales. But the damage would not be contained to wineries. Lower competitiveness with respect to cheaper foreign wine would also mean less investment in related wine storage, bottling and glass-making facilities, as well as suppressed demand for industrial- space construction in the county.

Meanwhile, residential market risks are twofold. The main risk is that the strong house price growth seen in the last three years will overpower median income growth, undermining affordability and the broader housing recovery. The other considerable source of risk is demographics. Thanks to its relatively warm weather and other local amenities, Sonoma County is expected to see an increase in its share of retirees over the next decade. However, any rise in living costs or erosion in housing affordability, signs of which were seen in 2014, could reverse this trend and cause a serious slowdown in population growth, dragging on both residential and retail-space construction.

Stronger Demand Will Drive CRE Prices Higher

Price per square foot in Sonoma County, % of peak



Sources: Real Capital Analytics Market Report, Moody's Analytics * Price per unit

Chart: *Prices for CRE will pick up in 2015, though gains will not be uniform. The recent increase in multifamily residential construction will increase rental vacancy rates and ease apartment rent price pressures, but rents will rise gradually in 2015 due to stronger demand. Declining vacancy rates will drive slight price growth in industrial and office space. Prices will rise faster for retail space, with low vacancy rates pushing up prices in Sonoma's downtown area and larger shopping complexes.*

Ilir Hysa
Tom McCartin
Jesse Rogers
Moody's Analytics

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With acknowledgement and appreciation to key local businesses that support economic development in Sonoma County

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Sonoma County Board of Supervisors

Economic Development Board
141 Stony Circle, Suite 110
Santa Rosa, CA 95401
(707) 565-7170
www.sonoma**edb**.org