


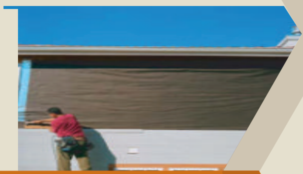

Industry Sector Report

Construction Industry Insider

2016
SONOMA COUNTY

SONOMA COUNTY EDB ECONOMIC DEVELOPMENT BOARD

Sonoma County Workforce Investment Board

2016

The Sonoma County Economic Development Board (EDB), in partnership with the Sonoma County Workforce Investment Board, is pleased to present the 2016 Construction Industry Insider for Sonoma County. Our research partner, Moody's Analytics, provided the research for this report.

Highlights of the 2016 Construction Industry Insider include:

- Stronger income growth will be the catalyst for unlocking pent-up demand for single-family homes and will pave the way for a modest rebound in homebuilding by the second half of this year.

- The market for commercial real estate tightened in 2015 and will make a stronger contribution to the recovery in construction over the next year. Vacancy rates for office, industrial and retail space fell swiftly over the past year and stand at their lowest levels in more than a decade.

- Sonoma County's lower business costs relative to San Francisco and proximity to major employers in the Bay Area make it a regional exception. Though office rents in Sonoma County rose more quickly than in San Francisco in the second half of 2015, the average cost of office space in the county is still less than half that of its larger neighbor.

- Declining affordability poses the greatest risk to the outlook for residential construction. House prices are rising at nearly twice the national average, and the widening gulf between median home prices and median family incomes could put homeownership out of reach for first-time homebuyers.

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
Pamela Chanter
Chair
Economic Development Board

Ben Stone
Ben Stone
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Recent Performance

Sonoma County made large strides in the second half of 2015, and its economy has returned to full health. Output, employment and incomes have recovered the ground lost during the Great Recession, and the county's economy is adding jobs at a faster pace than that of the U.S. economy. Tourism and viticulture—Sonoma's principal economic drivers—are fully engaged, and tech-related professional services also provide support. The jobless rate fell below the U.S. average in 2013 and ended 2015 at 4.3% even amid steady labor force growth.

The labor market is fast approaching full employment, and the greater competition for workers is lifting wages. Average hourly earnings rose steadily over the course of the year while the average workweek has lengthened.

Sonoma County's real estate market made halting progress in 2015. Though the nominal value of home sales reached its highest point since 2005 and house prices are rising at a steady clip, the mix is skewed toward sales of higher-priced homes. Median home prices have recovered 75% of their peak-to trough loss, but sales volume sits well below its trend prior to the housing boom and rose only moderately over the course of 2015. Flagging sales of existing single-family homes kept builders on the sidelines and prevented a broader recovery in residential construction from taking hold. Issuance of construction permits for single-family homes remains at a four-year low as multifamily units make up an outsize share of homebuilding.

Macro Drivers

The U.S. economy decelerated in the second half of 2015 as energy firms cut back on investment and the strong dollar depressed exports. Widening credit spreads and greater uncertainty provoked by China's slowing economy and its spillover effects to emerging markets also subtracted from growth. Despite these challenges, the economy advanced by 2.4% in 2015, shy of expectations at the start of the year but on par with its average over the course of the recovery. The Moody's Analytics forecast calls for the economy to advance at a similar pace this year, sustained by greater consumer spending and a stronger recovery in the housing market.

The modest outlook for output growth stands in contrast to the white-hot labor market. The economy added 2.7 million jobs in 2015 on top of the 3 million positions created the prior year. Together, the two years represent the best back-to-back performance for the job market since 1998-1999, when the tech stock bubble was in full swing. At the current pace of gains, the labor market will reach full employment by this summer.

Full employment will bring tangible benefits for the economy, most importantly in the form of better wage growth. The pickup in wages will do more to lift consumer spending. Better wage growth will also help households accumulate sufficient savings for a down payment, boosting household formation, home sales and residential construction.

Low productivity remains a hurdle and explains in part why, despite less than spectacular output growth, the job market has logged such strong gains. Though businesses faced few incentives to invest in labor-saving technologies earlier in the recovery, this is beginning to change as the job market tightens and wage growth accelerates. Business formation—a proxy for risk-taking and innovation—has regained its long-term trend and is especially strong in professional services and the software industry. As the labor market reaches full employment and additions to the labor force become scarcer, the economy's potential will hinge on improvements in productivity, with large consequences for living standards, household wealth, and the nation's fiscal position.

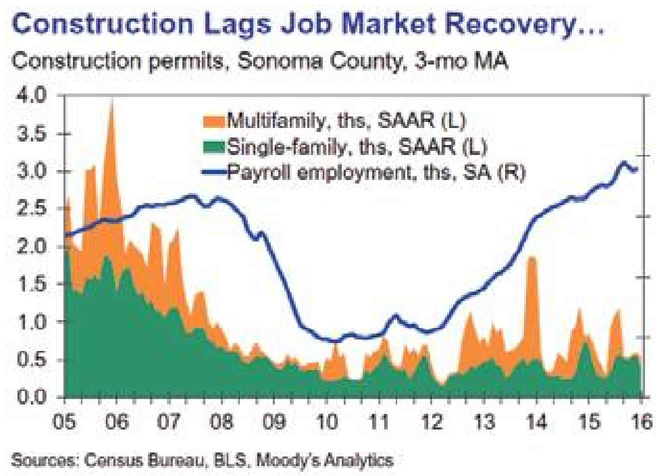

Chart: *Construction in Sonoma County has been slow to lift off, and residential construction made little headway in 2015. Despite faster private sector job growth, the pace of single-family home-building has not advanced noticeably since hitting bottom in 2009, and the apartment market has absorbed the bulk of new household formation. However, as the labor market nears full employment and wage growth accelerates, more households will take the plunge into home-ownership, lifting home sales and new single-family construction.*

Industry Drivers

Construction in Sonoma County struggled to gather momentum in 2015 and in early 2016. Despite stronger private sector job gains, the pace of singlefamily construction has not meaningfully accelerated since hitting bottom in late 2009, and new multifamily units have accommodated most new households. Commercial construction advanced at a slightly faster clip as developers broke ground on new office and retail space, and the dollar volume of nonresidential permits rose modestly over the past year.

Stronger income growth will be the catalyst for unlocking pent-up demand for single-family homes and will pave the way for a modest rebound in homebuilding by the second half of this year. The belated rise in wage growth and historically high rents have hurt households' ability to save for a down payment, tempering home purchases over the course of the recovery. However, this will change this year as better income growth and greater access to mortgage lending encourage households to take the leap into homeownership. The housing inventory, in terms of months of sales, is exceedingly tight, and a comparison of single-family completions to household formation points to significant excess demand.

Mortgage credit quality has improved markedly, and sturdier household balance sheets will support a rise in mortgage lending. According to Equifax, the share of first mortgages that are in delinquency or some phase in the foreclosure process has fallen below 2%, the lowest rate since early 2006, while delinquency rates for auto, bank and credit card loans are at or near prerecession levels. Foreclosures are no longer a significant burden on house prices or construction, and distressed properties have fallen to just a fraction of total home sales.

Multifamily construction is advancing at a torrential pace. The rental vacancy rate in Sonoma County has fallen steadily through 2013, according to the American Community Survey, but more recent data are hard to come by. However, Zillow listings for Sonoma County showed that listed rents for condos and co-ops rose swiftly over the past two years, in line with our analysis of recent market tightening. The proportional rise in the cohort of young adults, age 20 to 35, will keep demand for multifamily units elevated over the next few years, but its share of total construction will gradually decline as first-time buyers gain the wherewithal to purchase homes and as rising rents make homeownership more attractive.

The market for commercial real estate tightened in 2015 and will make a stronger contribution to the recovery in construction over the next year. Vacancy rates for office, industrial and retail space fell swiftly over the past year and stand at their lowest levels in more than a decade, according to Keegan & Coppin Co. At 16%, the office vacancy rate for Sonoma County has fallen nearly 10 percentage points from its high in 2009. Low vacancies in the Santa Rosa and Petaluma submarkets have helped to spur new construction, but the balance of the market still tilts toward oversupply.

Meanwhile, competition is intensifying for industrial and retail space. Sonoma's bottlers, craft spirits producers, and artisanal food makers are quickly expanding into facilities formerly occupied by telecom and medical device manufacturers, while developers are struggling to keep up with demand for retail space.

Short-term pricing

Pricing power for homebuilders will firm as wage growth accelerate and household formation picks up steam. The tight local housing market will play to homebuilders' advantage in the near term as a shortage of homes for sale prompts potential buyers to bid up prices. The rise in the retirement cohort over the next five years will raise demand for smaller, lower-priced homes, but this will be offset by an increase in trade-up buyers, the latter of which tend to purchase larger properties.

Apartment rents will remain high in the near term as the improving economy enables recent college graduates and younger adults to strike out on their own. Even with a large pipeline of multifamily projects, strong demand will keep vacancies low and aid multifamily developers' ability to raise prices. Prices for commercial real estate will rise, but gains will not be uniform. Greater competition and falling vacancy rates will drive steady price gains for retail space. In contrast, vacancy rates for office and industrial space are still well above historic lows. While fast-growing food and beverage makers are occupying more space, there is still a large inventory of vacant industrial space.

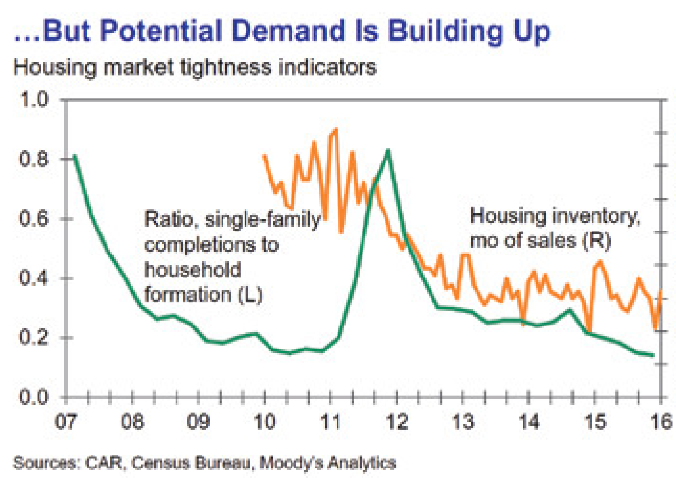

Chart: *There is substantial demand for new housing in Sonoma County, provided that income and credit growth are there to sustain it. At three months of sales, the housing inventory is just half of what is considered to be a balanced market, while the pace of single-family completions is badly lagging household formation. Stronger income growth this year will be the catalyst for unlock-ing pent-up demand for single-family homes, while robust popu-lation gains and above-average income growth bode well for the long-term outlook.*

Supply-side relief

Although input costs for labor and materials are not included in the baseline forecast, the steep decline in lumber, steel and copper prices is an upside risk for construction. After spiking in 2010, steel and copper prices steadily declined and stand at their lowest point since 2007. Lumber prices have also fallen and stand at mid- 2012 levels. The decline in metals and nonenergy commodity prices will not soon reverse, and slowing industrial output in China and East Asia will temper demand pressures and thus suppress costs for building materials over the next year. The extended drop in oil prices will be a further tailwind for residential and commercial builders, as construction machinery relies primarily on diesel fuel.

County-level data on raw materials are not available, but the Engineering News Record building cost index for Greater San Francisco grew more slowly last year, a sign that falling materials prices are taking some of the bite out of rising labor costs. Though construction payrolls in Sonoma County have recovered just half of their recessionary losses, hiring is far outpacing that in the broader economy, and average weekly pay for construction workers in the county is rising at nearly three times the rate of inflation. The torrential pace of hiring and rapid wage gains support the anecdotal evidence of a shortage of skilled construction workers. Though labor costs will rise as the housing and commercial markets gather steam, lower materials and fuel prices will ease overall cost pressures.

Returns

Steady house price appreciation and slower growth in input costs will boost margins and increase profitability for home-builders. However, returns for commercial real estate will be slower to rise, as vacant space, especially for office struc-tures, will limit pricing power. Return on investment in commercial real estate in the West 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 lower business costs relative to San Francisco and proximity to major employers in the Bay Area make it a regional exception. Though office rents in Sonoma County rose more quickly than in San Francisco in the second half of 2015, the average cost of office space in the county is still less than half that of its larger neighbor. Lower rents alone are unlikely to attract larger tech and financial firms, but higher costs are already pricing small and medium-size firms out of the San Francisco market. Many are relocating to neighboring Oakland or Marin County, but the search for more affordable office space will present an opportunity for developers in Sonoma County.

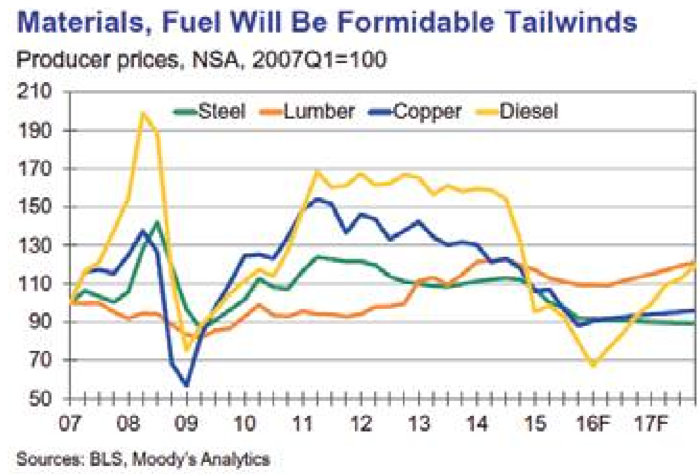

Chart: *Residential and commercial builders will contend with rising labor costs over the next 18 months, but falling prices for building ma-terials and diesel fuel will ease overall cost pressures. A global glut of copper and steel will depress prices over the next two years, and while prices for lumber and diesel fuel will recover more quickly, the steep decline will provide relief for builders through the end of this year. All told, falling materials prices will help to contain input costs and will improve returns for residential and commercial developers.*

Long-term Outlook

Strong demographics, proximity to San Francisco's supply-constrained market, climate, quality of life, abundant recreational opportunities, and above-average personal income growth bode well for residential construction in the long run, although a return to the 2005 boom in single-family construction is not likely. In-migration from North Bay counties has rebounded in recent years and the influx of residents from outside the metro area will drive housing demand. Millennials will soon account for the largest share of first-time homebuyers, and greater student debt burdens and a tendency to postpone household formation will apply restraint. Single-family construction will thus proceed at a more moderate pace as new homebuyers gradually step into the market.

After several lean years, the prospects for commercial development are more upbeat. Fierce competition for retail space is already prompting new construction. Robust growth in healthcare and life sciences research will increase net absorption of office space and pave the way for a modest rise in new commercial construction over the next few years. Sonoma's bottlers, distillers, and craft beverage producers will drive absorption of industrial space, although a scarcity of larger facilities could prompt some firms to move production outside of the county.

Upside Risks

A prolonged period of low energy prices is a significant upside risk for residential and commercial construction. A deeper than expected decline in energy prices would aid household balance sheets and purchase demand while also lowering input costs for residential and commercial builders. A sharper than expected drop in materials costs is another source of upside risk and would further lift profits for residential and commercial builders in the medium term.

Though the chances for comprehensive immigration reform are low in the near term, the passage of a bill to boost legal immigration would improve the medium-term outlook for Sonoma County's housing market. A larger immigrant population would first and foremost assure Sonoma's grape growers a more stable supply of labor, but it would also boost household formation and demand for housing. Greater immigration would initially favor multifamily construction, but as immigrant households accumulate savings, demand for single-family homes would also rise.

Downside Risks

Further appreciation of the U.S. dollar would strike at the heart of Sonoma's wine industry and thus deal a setback to the broader economy. Greater dollar appreciation vis-à-vis the euro and emerging market currencies would increase import competition while squeezing wine exports. However, the hurt would not be contained to wineries.

The vigorous expansion of food and beverage makers, bottlers, and glass-making facilities has increased net absorption of industrial space, and greater import competition would deal a significant setback to industrial developers in the county.

Declining affordability poses the greatest risk to the outlook for residential construction. House prices are rising at nearly twice the national average, and the widening gulf between median home prices and median family incomes could put homeownership out of reach for first-time homebuyers. Sonoma County is expected to experience an increase in its share of retirees over the next decade, but a rise in living costs or a decline in affordability could reverse this trend. The resulting blow to population growth would drag on residential and retail development.

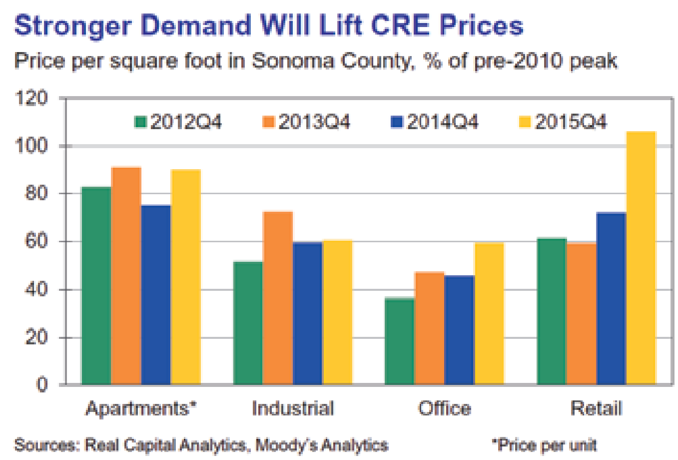

Chart: *CRE prices will strengthen, though gains will not be uniform. Prices for retail space will rise fastest, with low vacancy rates pushing up prices in downtown Santa Rosa and in Sonoma's larger shopping complexes. Apartment prices have cooled after reaching a new peak in the third quarter of 2014, and the large pipeline of multifamily projects will curb rent growth. Declining vacancy rates will elevate prices for industrial space. Price growth for office space will be the weakest because of a still-large amount of vacant space as well as competition from office developments in other North Bay counties.*

Jesse Rogers
Moody's Analytics

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