



INDUSTRY INSIDER **CONSTRUCTION**

INDUSTRY REPORT

2017



EXECUTIVE SUMMARY

April 2017

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

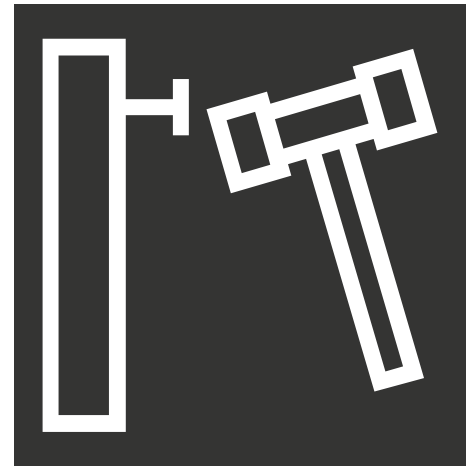
HIGHLIGHTS



Vacancy rates for office, industrial, and retail space are hovering at multi-decade lows, and absorption in all three markets is markedly positive. Nonresidential builders have responded by increasing construction. The dollar value of nonresidential permits increased by a quarter in 2016 and is chasing its long-run average. Commercial developers stand to benefit as fast-expanding food and beverage makers and hospitality operators bid up prices for new and existing commercial space.



Even though the price premium for new single-family homes has narrowed over the past year, single-family construction remains more than a third below its pre-housing boom pace. Low inventory in the market for single-family homes led to accelerated home price appreciation in the past year. As house prices in more markets surpass prior peaks homeowners will gain the confidence to list, alleviating the exceedingly tight supply of existing homes for sale and helping bring housing supply in line with demand.



Multifamily construction is going strong but has eased slightly from its peak in 2015. The deceleration is likely the result of capacity constraints as demand-side fundamentals are strong. The rental vacancy rate has declined in recent years and stood at 1.8% in 2015. The high premium for single-family homes will keep multifamily construction elevated. However, the shortage of construction workers has emerged as a supply-side constraint: the ratio of construction workers to total units under construction is at a multi-decade low.

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.



Recent Performance. Sonoma County is easing off the accelerator after outpacing California's other midsize metro areas for much of the past two years. Though pivotal winemaking, food manufacturing, tourism and technology industries remain potent drivers, the economy is settling into a more modest pace of expansion as the labor market nears full employment and the pool of idle workers thins. Not only has the jobless rate fallen to its lowest point since the height of the tech boom in the late 1990s, but the ratio of total employment to the working-age population, which includes workers who are not actively seeking employment, is at a record high, a sign that slack in the labor market is increasingly spare.

Greater competition for workers is lifting wages, and the gap in weekly earnings with the U.S. has narrowed over the past year.

The residential real estate market has regained its footing, but there is still work to be done. While house prices have recovered nearly all of the ground lost in the recession, the tight inventory has restrained home sales. Construction of new single-family homes has turned up for the first time since 2010, but total starts and permits have regained less than half of their prerecession pace. Finally, even though better job and wage gains are boosting housing demand, rapid house price gains have severely strained affordability.

The commercial real estate market has tightened and is helping to lift construction employment and building activity. Prices for commercial properties are firming as county food and winemakers, hospitality operators, and retailers expand.

Macro drivers. After six years of recovery, the U.S. housing market is making steady if unspectacular progress. Sales and residential construction have struggled to move higher in recent months. Although banks have eased mortgage lending standards, first-time and returning homebuyers have yet to enter the market in sufficient numbers to move the needle on home sales. Better job and income gains have facilitated balance sheet repair, but returning buyers have largely kept to the sidelines. The share of first-time buyers has risen from its post-recession nadir but is still below its long-run average. First-time and returning buyers' caution has tilted the construction mix toward multifamily units.

Total housing starts seesawed lower in the first few months of 2017, but the long-run trend remains positive. Multifamily

construction, which has accounted for the bulk of household formation in recent years, has begun to cool as builders contend with a shortage of skilled construction workers. With multifamily starts running at their highest rate since the 1980s, the shortage of experienced construction workers has emerged as a significant supply-side constraint: Both the ratio of construction workers to total units under construction and the jobless rate for skilled construction workers rest at multidecade lows.

Worker shortages do not represent an overwhelming obstacle for single-family homebuilders, if only because of subdued purchase demand. Adjusting for the number of households, existing-home sales are still a ways away from their long-run average, and low turnover has weighed on demand for new homes. Even though the price premium for new single-family homes has narrowed over the past year, single-family construction remains more than a third below its pre-housing boom pace.

Low inventory is an even larger concern and explains why, despite little movement in home sales, house price appreciation has accelerated noticeably over the past year. However, as house prices in more markets surpass prior peaks, homeowners will gain the confidence to list, alleviating the exceedingly tight supply of existing homes for sale and helping to bring housing supply in line with demand.

Industry drivers. The housing market recovery in Sonoma County is finally under way. Although the sparse selection of existing homes for sale has slowed buyer activity over the past year, single-family construction is trending higher and extended its run in January. As house prices crest their prerecession peak, more households will recover remaining equity lost in the housing bust. The uptick in homeowner confidence will encourage more owners to list, alleviating the current shortage of existing homes for sale.

As the local labor market reaches full employment, better wage gains will unleash pent-up demand for single-family homes. However, the increase in home sales and new construction will fall short of prior expansions because of slower population gains and the erosion of housing affordability in the county.

After improving in the wake of the housing bust, housing affordability has deteriorated noticeably in recent years as the increase in median house prices outstripped the rise in median family incomes. According

to the Moody's Analytics Housing Affordability Index, the share of median income needed to purchase a median-priced home has risen sharply in recent years and is among the highest of midsize California metro areas. The high cost of housing will limit potential residents' ability to purchase homes in the county, placing a ceiling on housing demand.

The Federal Reserve is expected to resume its course of monetary normalization this year, but higher borrowing costs will not halt the local housing recovery. Even as mortgage rates rise, better income gains and sturdier household balance sheets will support mortgage lending. According to Equifax, delinquency rates across most credit segments are at or near long-run averages. While lending standards remain strict, the credit spigot is slowly loosening. The share of first mortgage balances with credit scores below 700 has begun to increase for the first time in nearly a decade.

Multifamily construction is going strong but has eased slightly from its earlier peak in 2015. The deceleration is likely the result of capacity constraints. Demand-side fundamentals are strong and show little sign of waning. The rental vacancy rate has declined precipitously in recent years and stood at 1.8% in 2015, according to the American Community Survey. More recent data are hard to come by, but Zillow listings for Sonoma County indicate that demand is still on the upswing: the median asking rent for apartments rose 4.5% in 2016 and is up a stunning 44% since 2010, compared with just 20% for the rest of the state. Though the mix will begin to tilt toward single-family construction as first-time buyers gain the wherewithal to purchase homes, the high premium for single-family homes will keep multifamily construction elevated.

The commercial real estate market is stretching its wings as lower vacancy rates and firming demand spark new construction. According to Keegan & Coppin Co., vacancy rates for office, industrial and retail space are hovering at multidecade lows, and absorption in all three markets is markedly positive. Nonresidential builders have responded in kind: The dollar volume of nonresidential permits increased by a quarter in 2016 and is chasing its long-run average.

As Sonoma County food manufacturers, wineries, craft breweries, and hospitality operators push ahead with plans for expansion, competition for space will intensify. In particular, the market for industrial space is

approaching critical tightness. Demand for new industrial space will push fast-growing food and beverage makers to invest in new facilities.

Short-term pricing. The tight inventory of existing homes for sale will bolster homebuilders' pricing power in the near term. Although house price appreciation will settle into a more sustainable rate by the end of this year, prices for existing single-family homes will nonetheless outpace inflation, and the steep price premium for new homes will protect pricing power. As first-time homebuyers and retirees enter the market in greater numbers, the mix of home sales will tilt toward smaller properties. Still, much of this increase will be offset by strong demand among trade-up buyers.

Record low vacancy rates will push prices up for multifamily projects. Though apartment rents will rise less quickly over the next year, they will remain elevated as the improving economy enables more college graduates and young adults to strike out on their own. Though the backlog of multifamily projects is lengthening, strong demand will safeguard pricing power.

The ferocious expansion of county food and beverage makers will revive industrial developers' ability to raise prices. Retail developers will also retain pricing power as hospitality operators and retail stores expand. Pricing in the office market, however, will remain soft because of lower absorption and greater availability of vacant space.

Operating expenses. Homebuilders' honeymoon from rising costs will come to an end this year as rising labor expenses outweigh soft commodity prices. Global oversupply of steel, copper, and other building supplies provided residential and nonresidential builders with significant cost savings last year, but rising labor costs will soon eclipse the boost from lower-cost building materials. Additionally, while diesel prices will remain well below their mid-2014 peak, the rally in crude prices last fall is already feeding into higher prices for diesel and other petroleum derivatives and will raise fuel costs for diesel-reliant construction machinery.

Timely data on county-level raw materials and labor costs are not readily available, but the Engineering News Record building cost index for Greater San Francisco rose at nearly double the national rate last year as higher labor costs pushed up overall construction costs. More lagged data from the Quarterly Census of Employment and Wages suggest that rising

labor costs are indeed manifest at the county level. Weekly pay for residential construction workers and specialty trade contractors is rising at nearly twice the rate of inflation.

Returns. Return on investment will improve even in the face of rising labor costs. Though prices for residential and commercial real estate will increase less rapidly this year, they will still outpace gains in construction wages. As the local labor market tightens and more households take the plunge into homeownership, home sales and new residential construction will rise in kind. Given capacity constraints in the multifamily market, there is risk that wage increases needed to lure additional workers will compress margins. However, robust demand will mean that developers will be able to pass on most of the increase in the form of higher rents.

Returns on commercial real estate have been remarkably stable since 2011, but there is reason this year to expect better gains. With the vacancy rate for industrial and retail properties at just half of what is considered a balanced market, commercial developers stand to benefit as fast-expanding food and beverage makers and hospitality operators bid up prices for new and existing commercial space. Finally, while Sonoma County has been slow to latch on to the broader Bay Area tech boom, many smaller tech and financial firms are relocating from San Francisco to Oakland and Marin County, and the search for more affordable office space creates opportunity for developers.

Long-term outlook. The residential and commercial real estate markets share an optimistic long-run outlook, but worsening housing affordability will loom large. Revised population data indicate that net-migration slowed substantially in the past few years, a period coinciding with deteriorating affordability. Should housing costs increase further, fewer potential residents and entrepreneurs will be able to purchase a home in the county. Lower in-migration would keep housing demand at a simmer.

The changing of the demographic guard is at hand, and millennials' tendency to postpone homeownership will also apply restraint. Still, better income gains and improved job prospects will stir more young households to take the plunge into homeownership. This would boost home sales and new construction.

The feverish pace of expansion at local food, beverage, consumer goods and hospi-

tality operators will create fertile ground for commercial developers. However, construction of new office buildings will proceed at a more modest pace as office-using industries expand into existing space.

Upside risks. Improved housing affordability as a result of more modest home price increases or faster income gains endows the outlook for residential construction with considerable upside risk. The county's natural beauty, abundant outdoor recreation opportunities, proximity to the Bay Area, and relatively low business costs are all factors that make Sonoma attractive to potential residents. However, supply constraints and tight building codes will make further gains in affordability an uphill climb.

Rising office and industrial rents in the San Francisco Bay Area are an upside risk for county developers. With the average cost of office space in Sonoma less than half its larger neighbor, the county offers considerable cost savings to potential tenants. Lower office and industrial rents alone are unlikely to encourage large tech and financial firms to relocate to the county, especially because locally based tech firms are already grappling with a shortage of college graduates in science and technology fields. However, with many smaller biotech firms already migrating to Marin County, low office rents could draw some firms further north.

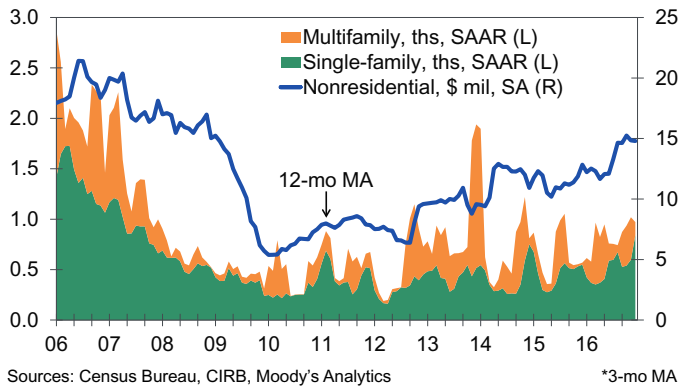
Downside risks. Restrictive trade and immigration measures favored by the new Trump administration pose a downside risk to Sonoma County wineries, food manufacturers and hospitality establishments, but the hurt from potential trade or labor supply shocks would also be felt in the commercial real estate market. The vigorous expansion of wineries, bottlers, food manufacturers and hospitality operators has revived demand for commercial real estate, and any blow to county exporters would extend to the industrial and retail markets.

A faster than expected increase in short-term interest rates poses a risk to single-family housing demand. Although the risk premium for mortgage lending has fallen to its pre-housing boom average, a faster rise in short-term rates would soon push up the cost of mortgages. First-time and returning buyers, who rely more on mortgage lending, would bear most of the burden, and the resulting slack in purchase demand would sap the housing recovery's mojo.

*Jesse Rogers
March 2017*

Construction Recovery Is Finally Under Way

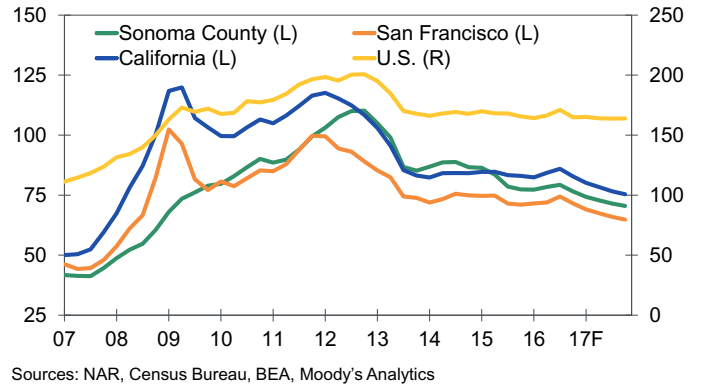
Construction permits, Sonoma County*



Residential and commercial builders in Sonoma County closed out 2016 with the first sustained increase in construction activity in more than a decade. Though capacity constraints have slowed the pace of apartment construction, better wage gains have stirred more households to take the leap into homeownership, boosting home sales and new single-family construction. The ferocious pace of expansion among winemakers, food and beverage producers, hospitality operators, and retailers has pushed down vacancy rates and will support new commercial construction.

Housing Affordability Is Low and Declining

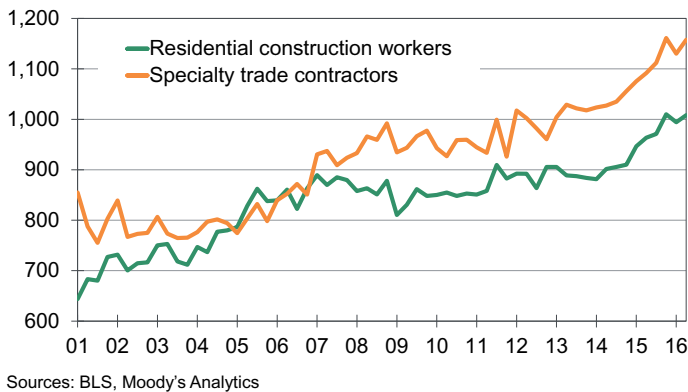
Composite housing affordability index



Housing affordability will be the watchword for Sonoma County's residential real estate market. Median house prices continue to eclipse growth in median family incomes, making the county among the most expensive of mid-size California metro areas. Though the county's high quality of life and relatively low business costs make it attractive to potential residents and entrepreneurs, the deterioration in housing affordability will deter in-migration and keep potential housing demand well below its level in previous expansions.

Construction Wages Are Rising Quickly

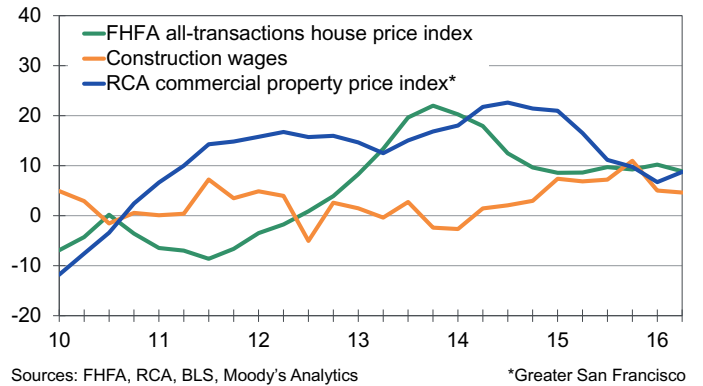
Avg weekly pay, Sonoma County, \$ ths



Residential and commercial builders will grapple with rising labor costs over the next year. The surge in multifamily building has strained the supply of construction laborers, and builders are bidding up wages for unskilled workers and specialized contractors alike. Though single-family and commercial builders face fewer workforce constraints, the sustained increase in single-family construction and new industrial and retail projects will further stimulate wage growth. Rising labor costs will offset the dip in commodity prices and will push up overall construction costs.

Rising Property Prices Will Outstrip Labor Costs

% change yr ago



Given robust demand, residential and commercial builders will be able to pass along higher labor costs in the form of higher rents and list prices. Though total construction wage growth briefly eclipsed the rise in commercial real estate and house prices in late 2015, house price appreciation and CRE prices have once again quickened their step. As rising property prices outstrip the increase in labor costs, builders' return on investment will strengthen.



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