Industry Sector Report

Construction Industry Insider

2014
SONOMA COUNTY

2014 Construction Industry Insider

June 2014

The Sonoma County Economic Development Board (EDB), in partnership with the Sonoma County Workforce Investment Board, is pleased to present the 2014 Construction Industry Insider for Sonoma County. Our research partner, Moody's Analytics, provided the research for this report.

Highlights of the 2014 Construction Industry Insider include:

- After a long period of flat activity, construction in Sonoma County is showing signs of life through resurgence in inventory-to-sales-ratio, house price gains, residential permits and construction employment.

- Though multi-family permits and non-residential permit dollar volume have increased since mid-2012, single-family permits are still at a cyclical bottom. Sonoma County's overall construction activity has not regained prerecession volume and will not do so for another two years.

- Due to changing demographics, a return to a 2005 boom in single-family construction is extremely unlikely, and total residential construction will grow at a more moderate pace than the pre-2003 average, with more emphasis on multifamily or commercial construction.

- The county's office and industrial space prices grew at a faster pace in the second half of 2013 compared with San Francisco and Oakland. Despite a moderate outlook for the construction industry, Sonoma County might benefit from geographic linkages to Greater San Francisco through business relocations.

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
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Sonoma County: Construction Industry Insider

Recent Performance

Sonoma County's recovery solidified near the end of 2013 as core consumer-dependent industries strengthened and a major tribal casino entered operation. The classification of tribal casino payrolls as part of local government caused an upward jump in public sector payrolls while also understating the private sector recovery, where hiring in tourism-related industries and business services points to real strengths. The unemployment rate slipped below 6% for the first time since mid-2008, even as the labor force participation rate stabilized. Bolstered by an improving job market, consumer credit in the county is increasing. The delinquency rates for all types of credit balances are now below statewide and U.S. rates and have almost returned to their prerecession trend.

Some signs of cooling are visible in real estate. House price appreciation eased at the end of 2013 but restarted in January and February as sales fell by more than 10% from a year earlier, according to the California Association of Realtors. Prices have recovered 45% of their earlier peak-to-trough loss, under the 50% statewide recovery. Home sales in 2013 have been flat, but only because of a sharp decline in short- and real estate-owned sales that offset an equally strong increase in nondistress sales. Permit issuance has edged upward modestly since the beginning of 2013 but has recovered less than 20% of the peak-to-trough decline experienced from 2006 to 2010. Construction of multifamily units has been the primary driver to date, though nonresidential permit dollar volume is at last starting to edge upward.

Macro Drivers

The U.S. economy grew in 2013 by 1.9%, slightly below the rate forecast at the beginning of the year. A faster recovery was hindered by the budget stalemate in Washington DC that finally ended in October, by softness in the housing market at the end of the year, and by disappointing performance in emerging markets that may have slowed export growth. Although increased inventories accounted for much of last year's growth, the economy surmounted a weak first quarter to achieve steady growth excluding inventories. Household balance sheets have improved, debt performance is better, and businesses remain highly profitable.

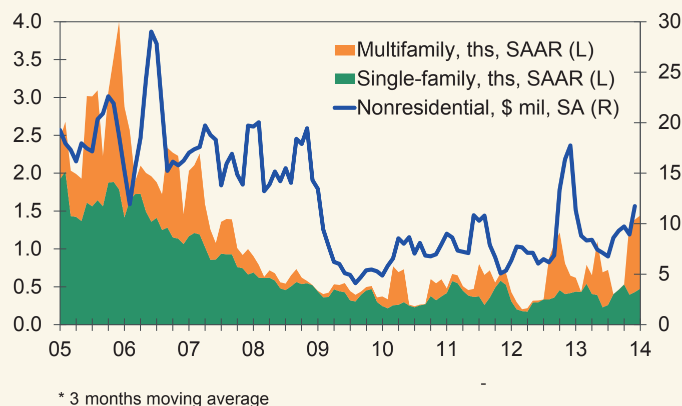
With fundamentals remaining solid, real GDP is expected to rise around 3% in 2014 and accelerate to 4% in 2015 as the economy transitions into expansion. Surging domestic energy production that cuts into imports and helps give manufacturers in the U.S. a cost advantage and a liquid, well-capitalized financial system will be primary drivers of growth in the near to medium terms. The earlier risk of political brinkmanship in Washington DC has fallen. The termination of quantitative easing on the part of the Federal Reserve is on schedule and, while reducing easy credit, will act to diminish unsound lending and slow the growth of new credit bubbles.

The Fed will steadily increase longterm interest rates in response to continued recovery, without hindering a financial sector that is now years removed from a normalized monetary policy.

Developments in the labor market have been mixed. The U.S. unemployment rate has fallen rapidly to 6.7% in March, down from 7.9% at the beginning of 2013. Net job gains dropped to an average of 130,000 in December and January, half the average in the previous three months, but this is thought to have been affected by a combination of unsuitable seasonal adjustments and harsh winter weather; the February and March job gains are much better at over 190,000. In the wake of faster net job growth, the decline in labor force participation is reversing itself, while unemployment will continue to decline, albeit at a milder rate, and fall below 6% in 2015.

Single-Family Construction Lags the Recovery

Construction permits, Santa Rosa-Petaluma metro area*



* 3 months moving average

Sources: Census Bureau, CIRB, Moody's Analytics

Chart: *Except for brief bursts of multifamily or commercial construction, overall construction activity in Sonoma County has not regained prerecession volume and will not do so for another two years. This forecast seems paradoxical in that most fundamentals, including inventory-to-sales ratios and house price gains, point to an immediate resurgence in single-family construction at the very least. However, though residential permits and construction employment have started to pick up, it is most likely a shortage of skilled construction workers that has slowed down residential construction.*

Industry Drivers

After a long period of flat activity, construction in Sonoma County is showing signs of life, though the start of recovery is of course uneven. Multifamily permits and nonresidential permit dollar volume has increased since mid-2012, but single-family permits are still at a cyclical bottom.

This will change over the coming year, however, as the housing market is showing definite signs of excess demand. The ratio of unsold home inventories to sales is almost back to its prerecession low level, and a longer-term comparison of single-family completions to household formation and other sources of demand makes clear that there is a large amount of potential demand in the county's housing market, provided the income and credit are there to sustain it.

The long period of foreclosure inventory disturbing housing markets is also almost over. Foreclosed properties, as a percentage of total households, have fallen to their lowest level since RealtyTrac started keeping records in 2007, while CoreLogic indicates that distress sales have fallen to 10% of total sales after averaging in excess of 40% from 2008-2011. Nor are foreclosures likely to resume any time soon; Equifax reports that first mortgages in Sonoma County that are in delinquency or some stage of foreclosure have fallen to 3% of all first mortgages, down from a peak of over 11% in 2010, and Moody's Analytics expects this downward trend to continue.

Multifamily construction saw a healthy increase between mid-2012 and the end of 2013, averaging almost 500 annualized permits in this period, but it is unlikely that this pace can be sustained. This previous burst in activity was fueled by rental market tightening; there was a substantial increase in median gross rent above the rate of increase for both California and the U.S., according to the 2012 American Community Survey. However, estimated multifamily completions have edged up over the past year, and 2012 rental vacancy rates were already increasing before the burst in new multifamily construction. More recent data are harder to find, but Zillow listings for Sonoma County indicate that listed rents and rents per square foot for condos and co-ops have leveled out over the past nine months, indicating a cooling off in the rental market.

The non-apartment commercial real estate market has been more steady but uneven, and has more need for tightening before it can contribute to a construction recovery. Vacancy rates in office, industrial and retail markets have trended down over the past three years as reported by Keegan & Coppin, but the overall vacancy rate for office space remains at an elevated 20.1%, still substantially above prerecession rates; the 10% vacancy rate for industrial space is much better but is still slightly above the long-term average. Despite this slow progress, absorption in all three markets is markedly positive; commercial real estate in the county is not depressed by any means, but still working off the excess inventory built up in prerecession years, especially for office space. The employment totals are consistent with this picture.

Retail payrolls have already exceeded their prerecession peak, while warehouse jobs have recovered more than half of recession job losses, whereas officeusing and manufacturing payrolls have only just started to recover in comparison.

Short-term pricing

The outlooks for commercial and residential real estate prices point in opposite directions. For single-family homes especially, lagging construction combined with steady household formation has created a lot of potential demand as well as increasing the average age of existing homes, while inventory-to-sale ratios are lower than historical averages. This means that there will be a substantial push for residential construction in the coming two years. Also, price gains in 2012-2013 wiped out most of the undervaluation in the county's stock of single-family homes, thus reducing investment opportunities and upward price pressure. Over the coming five-year period, the proportion of the post-retirement age population in Sonoma County will increase by 3% to 4% at the expense of the population aged 35-49; consequently, there will be greater proportional demand for smaller homes and a slight shift away from single-family homes. As such, single-family house price growth will be more subdued over the coming period compared with 2012-2013, especially once newly completed homes start to enter the market in larger quantities.

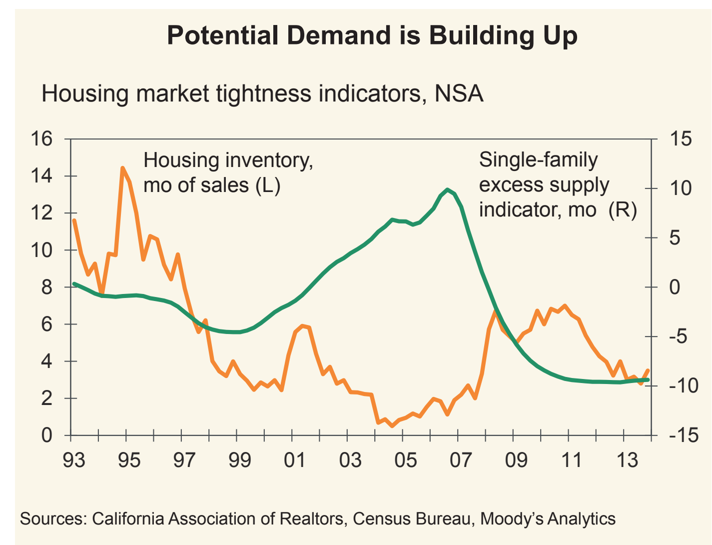


Chart: *The slowness of the recovery in residential construction is certainly not due to excess supply. Inventory-to-sales ratios for Sonoma County are trending down and have reached their lowest point since the start of the last recession. The more medium turn indicators also point to tightness. In particular, the growth of singlefamily homes has trailed household formation, vacation home demand, and obsolescence. As always, the chief culprit seems to be affordability, as real median household income in the county has only recently started to increase after years of decline.*

While there will most likely not be a slowdown in commercial property prices, gains will not be rapid either. According to Real Capital Analytics, apartment prices in the Santa Rosa-Petaluma metro area have increased the fastest up to 2013 but are almost back to prerecession highs; the current spurt in multifamily constructions will soon put a brake on price growth. Retail space price growth leveled off in 2013, while industrial and office space prices have not started to recover, which means there will not be a burst in commercial space construction over the coming year.

Supply-side concerns

Although not part of the baseline forecast, construction costs for both materials and labor pose a significant downside risk for Sonoma County. There are no data for the county itself, but the ENR building cost index for neighboring San Francisco, despite increasing at a rate close to its historical average over the past three years, has been subject to serious volatility, including substantial jumps in late 2010 and again in late 2013.

For the U.S. as a whole, the price deflator for nonresidential construction has grown at a steady rate, but inflation for residential construction costs exceeded 5% year over year at the end of last year, higher than at any time since the 2005 housing construction boom. Much of this increase can be traced to energy costs, particularly diesel fuel for construction machinery, but there is also concern about labor costs. The unemployment rate for skilled construction workers in the U.S. has fallen to below 10% as of March, almost back to its prerecession rate, but the skilled construction worker labor force is still close to a record low, and this might result in upward labor cost pressure over the coming years. As of 2012, the last year with data, average real wage income in Sonoma County was slightly below that of the U.S., but had started to increase rapidly at the end of the year. Though the construction labor market in the county is not critically tight, it might yet become so. The 2013 numbers, where construction permits in the county increased moderately from 2012 but total construction payrolls stayed level, are a possible warning sign of this risk.

Returns

There is no increasing profitability pressure on construction as of yet. The rate of return on commercial real estate calculated by the National Council of Real Estate Investment Fiduciaries for the West census region has been roughly level over the past three years on a transactions basis and has even declined slightly from 2012 on an appraisal basis. This stasis indicates that despite the shortfall in overall construction in the region over the past five years, there is not a large amount of upward price pressure relative to costs on real estate development at this point.

Of course, there are several aspects unique to Sonoma County that may make it a regional exception. Relocations from Greater San Francisco may already have started, as office and industrial space prices in Sonoma County grew at a faster pace in the second half of 2013 compared with San Francisco and Oakland. Despite an objectively moderate outlook, the county might yet benefit from geographic linkages.

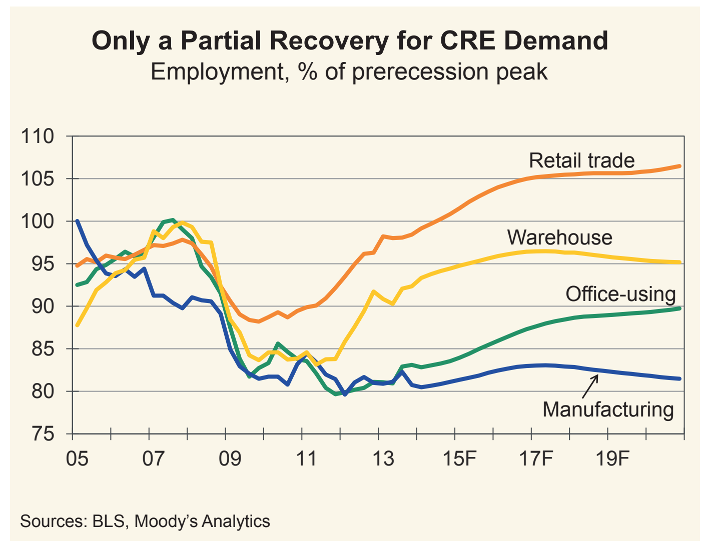


Chart: *Recovery in demand for commercial space will be long in coming and will have a different distribution compared with before the recession. Manufacturing employment will be the weakest driver, as wineries are the most prominent manufacturing industry and have already regained all of the jobs lost during the recession, while other manufacturing sectors have been stagnant and will experience only limited payroll growth. Office-using employment looks slightly better but will face downward drag because of a larger proportion of services preferring Marin County despite the higher rents.*

Long-term Outlook

Sonoma County is no exception to the general demographic outlook for the U.S., and its population will gray over time as the retiree population grows in comparison to households in their prime earning years. This means that a return to a 2005 boom in single-family construction is extremely unlikely, and total residential construction will grow at a more moderate pace than the pre-2003 average, with more emphasis on multifamily and attached singlefamily construction than in previous years.

Commercial space construction has a similar outlook; the long-term population growth trend of 0.7% through the mid-2020s, much slower than previous decades, points to slower growth in the demand for retail space, while the long-term corporate trend of relocating back-office operations to regions with lower labor costs also points against rapid office space construction in the coming decade.

Upside Risks

As always, the wine industry provides a considerable upward risk margin to the county, as world demand for wine is growing and generally steady. The wine industry already accounts for the lion's share of industrial space construction in the county, not so much for wineries as for related storage, bottling and glass-making facilities. Any boom in worldwide wine demand could see the industry becoming an even larger growth driver.

The other upside industrial risk is the county's growing logging industry. Logging wage income in the county grew 67% faster than in the U.S. between 2008 and 2013; further growth might see the local development of upstream industries such as processing and paper mills. Finally, a tightening commercial space market in the Bay Area might spill over to Sonoma County, with relocations helping to sustain the healthy price growth in 2013.

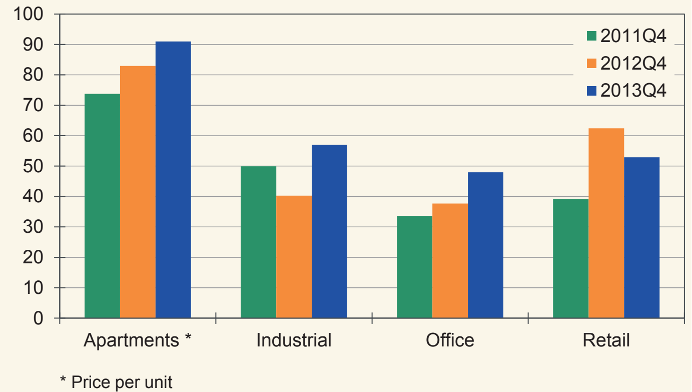
Downside Risks

Dependent as it is on diesel fuel, construction is one of the few industries in the U.S. that has not greatly benefited from the boom in natural gas production. Any increase in diesel fuel costs, possibly from increased cost of Canadian oil imports if the Keystone Pipeline is not built or if any large-scale accident increases safety restrictions, will impact construction profit margins throughout the U.S. A tighter than expected labor market for skilled construction workers is also a plausible national risk, and it might push up construction costs.

Risks specific to Sonoma County are more well-defined. For the residential market, the main risk is that the strong house price growth in 2012-2013 will continue without accompanying gains in job growth and median incomes, leading to serious erosion in affordability and a resulting hangover that leads to a temporary housing decline. The other considerable source of risk is demographics. Thanks to its location, Sonoma County is expected to increase its share of retiree residents over the next decade. However, any rise in living costs or erosion in housing affordability could reverse this trend and cause a serious slowdown in population growth, dragging on both residential and retail space construction.

CRE Prices Are Recovering but Still Weak

Price per square foot in Sonoma County, % of peak



* Price per unit

Sources: Real Capital Analytics Market Report, Moody's Analytics

Chart: *Apartment and commercial construction from the previous decade substantially expanded capacity and will drag on commercial real estate prices and construction. As in many other regions, the legacy factor was the large amount of CRE mortgage originations that took place in 2005-2007, which resulted in a wave of construction and an oversupply when the credit spigot shut off temporarily in 2008-2009. Even after the rebound in mortgage commitments, demand has been cautious and only the apartment market has regained most of its peak value.*

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