



INDUSTRY INSIDER CONSTRUCTION

INDUSTRY REPORT

2018



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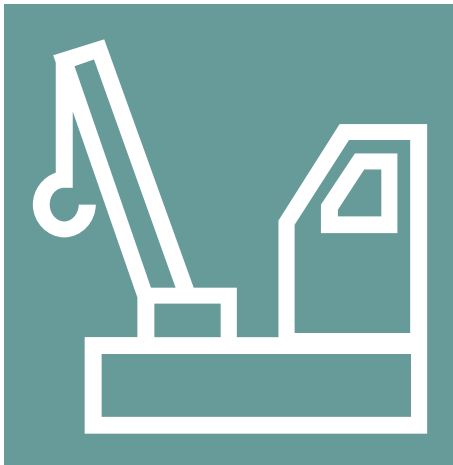


EXECUTIVE SUMMARY

March 2018

The Sonoma County Economic Development Board (EDB), in partnership with the Sonoma County Workforce Investment Board (WIB), is pleased to present the 2018 *Construction Industry Insiders* report. Our research partner, Moody's Analytics, provided the research for this report. For additional information, questions, comments, or suggestions please contact us at (707) 565-7170 or visit www.sonomaedb.org.

HIGHLIGHTS



Homes destroyed by the October 2017 wildfires exacerbated the pre-existing housing crisis. While the pace of single-family home construction has finally caught up to the household formation rate, it will take several years of above-average construction growth to correct the supply shock caused by the wildfires. Meanwhile, rents are projected to increase in the near-term. The ratio of construction workers to residential units under construction is at a historic low. Without intervention, it will take at least two years to rebuild housing units lost in the fires. Sonoma County will need to accelerate its homebuilding activity to new levels in order to bring supply in equilibrium with demand again.



Housing inventory continues to hover near historic lows, and median home sales prices continue to outpace the growth of median household income. While prices have grown, the volume of home sales has largely stagnated. Millennials' high levels of debt and propensity to delay marriage combine with sluggish wage growth to sharply depress the rate of first-time home buying; this effect will drive construction of multifamily units in the near-term. In the next few years, Millennials will shift to make up the majority of first-time home buyers, but with modest income gains, home sales will skew towards smaller, more modestly priced properties.



Housing affordability eroded in the wake of the fires, with thousands of families being pushed into rental markets or out of the county entirely. The county ranks among the fifteen least-affordable metro areas in the nation. Outside of Sonoma County, supply constraints plague California and the United States as a whole, resulting in minor housing crises across the county due in part to four years of underbuilding. Material costs of building has risen, and changes in the price of steel will especially affect homebuilding because half of U.S. steel is used in construction. Construction wages have grown at twice the rate of inflation, further increasing input costs. In Sonoma County, land constraints compound with increased input costs to dictate higher prices across all properties.



Recent Performance. Sonoma County's construction industry is in a race against time. Although the economy is gradually recovering from the October wildfires, the destruction of nearly 5,000 single-family homes has put inventories in a deep squeeze. Housing demand has finally recovered from the Great Recession, but the thin supply of new and existing homes for sale has deterred homeowners from listing. While the nominal value of home sales has reached a new high, the increase owes to higher-priced homes: Sales volume is barely higher than its post-recession nadir.

The job market in Sonoma County is exceedingly tight, and nowhere is this more so than in the construction industry. Although total construction employment has surpassed its pre-housing boom average, available labor is in short supply. Builders report fewer workers on site, and concerns over a shortage of skilled workers are borne out in the data. The ratio of construction workers to residential units under construction is at a multidecade low, and the pace of single-family homebuilding has severely lagged household formations. The slow pace of residential construction has kept inventories low. Meanwhile, rapid price gains in the wake of the wildfire-wrought supply shock have further eroded affordability.

The commercial real estate market in Sonoma County is in far better shape. Most commercial structures sustained limited damage in the Tubbs and Atlas fires, and growth in tourism, manufacturing and office-using industries has pushed commercial vacancy rates to new lows. Net absorption is positive across segments, and the county has welcomed several new office buildings over the past year.

Macro drivers. The U.S. housing market is on the path to recovery, but supply constraints will be a major bend in the road. After four years of underbuilding, the market for single-family homes is chronically under-supplied. Skilled worker shortages and rising material costs are now restraining the pace of single-family construction. The backlog of single-family homes under construction is near a record high, and while the price premium for new homes has fallen slightly, supply constraints linger. The jobless rate for experienced construction workers is at a cycle low, and the number of workers per unit under construction has fallen sharply across U.S. regions.

Low inventories have deterred homeowners from listing, and total home sales on a household-adjusted basis remain more than a third below their long-run average. Absent a significant jump in the number of homes on the market or a sharp slowdown in house price appreciation, inventories will remain low, driving a gulf between homebuyers and sellers.

High debt burdens and the delayed liftoff in wage growth will prevent first-time homebuyers from entering the market in large enough numbers to drive a sustained increase in home sales. Although housing demand has recovered in the aggregate—both purchase mortgage originations and the total volume of mortgage debt are within striking distance of prerecession peaks—the share of first-time homebuyers is still shy of its long-run average and will rise only gradually as wage growth improves and the acceleration in homebuilding increases listings. Millennials' tendency to postpone marriage will also weigh on demand and will keep apartment construction elevated over the next few years.

As inflation pressures build, the Federal Reserve will stay the course of monetary policy normalization. The Fed raised interest rates three times last year, and Moody's Analytics expects a 25-basis point increase per quarter and a decline in the central bank's balance sheet over the next two years. However, higher borrowing costs will not deter sales. Even with higher mortgage rates, better income gains and improving balance sheets will support mortgage lending. Outstanding balances for auto, bankcard, mortgage and home equity credit have risen steadily since 2016, while delinquency rates fell below prerecession levels across most loan segments.

Industry drivers. Residential construction in Sonoma County has finally turned up, but the pace of single-family construction will need to accelerate even more to bring supply back in line with demand. At the current pace of homebuilding, it will take at least two years to replace homes lost in the Tubbs and Atlas fires. Labor shortages and rising materials costs will make it all the more difficult to elevate the pace of residential construction. Average weekly pay for construction workers is rising at nearly twice the rate of inflation, while prices for key inputs such as lumber, steel and copper will continue to rise. Meanwhile, fuel costs will remain elevated after falling significantly in the past two years.

Although homeowners in Sonoma County have recovered most of the equity lost in the recession, the scarce inventory of new and existing homes for sale will make homeowners more reluctant to list. Housing inventory in months of sales is exceedingly tight, and the sparse selection of existing homes for sale has put a serious damper on buyer activity. Though a pickup in construction has meant that single-family housing completions have caught up to household formations, it will take several years of above-trend growth to bring supply and demand back into balance and alleviate the shortage of listings.

Housing affordability remains an even greater concern. The supply shock introduced by the October wildfires has pushed median house prices even higher, and with median house price growth eclipsing the rise in median household incomes, housing affordability has worsened. The share of median income needed to purchase a median-priced home has risen even prior to the fall blazes, and Sonoma County ranks among the top 15 least affordable metro areas in the nation. The additional decline in affordability following the fires will make it more difficult for families working in the county to live within its borders, and this will restrain labor force growth in the near and medium term.

By contrast, the commercial real estate market is firming. Net absorption is rising at the fastest rate in nearly two decades, and falling vacancy rates have sparked new construction: The dollar volume of nonresidential permits is closing in on its pre-housing-boom level and is only a fifth below its peak in the dot-com bust. Although new business formations have trailed those in the state's larger metro areas, growth in new establishments has outpaced that of the rest of the U.S. Restaurants, food and beverage manufacturers, and hotels have been a considerable source of growth.

Vacancy rates for commercial real estate are hovering at their lowest point in two decades, according to Keegan & Coppin Co., with the largest declines in industrial and office space. The surplus of office space in the wake of the dot-com bust has provided plentiful ground for food and beverage manufacturers and specialty life science firms to expand. Although the county has welcomed several new office buildings in the past three years, the majority of the decline in the office market has been driven by absorption of existing space. Likewise, the fall in industrial

vacancy rates owes primarily to the repurposing of old facilities, and construction of new structures has increased only modestly.

The retail market remains buoyant. Not only are developers unveiling new shopping centers, but growth in experiential retail such as restaurants, brewpubs, and local craft shops has pushed up prices and spurred the redevelopment of downtown areas in Santa Rosa, Petaluma and Healdsburg.

Short-term pricing. The shortage of existing homes for sale will play to homebuilders' advantage in the near term, although prices will rise more slowly as inventories gradually increase and residential construction accelerates in earnest. Having reached their pre-recession peaks and then some, median house price appreciation in Sonoma County will slow, matching the national average over the next few years. As more first-time homebuyers enter the market, the mix of home sales will skew toward smaller, more modestly priced properties, lowering prices for builders.

With more families moving into temporary housing in the wake of the Tubbs and Atlas fires, rents will spike in the near term. However, long-term demographic and economic trends—in particular high debt burdens among millennials—will buoy apartment prices this year and next.

Prices for commercial properties will rise steadily in the near term as growth in food and beverage manufacturing and tourism lifts industrial and retail demand. Although tighter inventory will prop up prices in the medium term, land constraints will cause firms to expand elsewhere, limiting upward pressure on prices.

Operating expenses. Both commercial and residential developers will face higher costs. An increase in lumber, steel and copper prices alongside accelerating wages for construction workers will raise operating expenses. Prices for lumber, steel and copper tumbled to a two-decade low in 2016, but faster construction and the synchronous global expansion have boosted materials and fuel prices. More granular data on raw materials and labor costs are not readily available, but the Engineering News Record building cost for Greater San Francisco once again outpaced the national rate last year as higher labor and materials costs pushed up overall construction expenses. This is consistent with more lagged data from the Quarterly Census of Employment and Wages suggesting labor costs are rising at the county level.

Wages for framers, masons and specialty contractors are rising almost as fast as Sonoma County house prices. With materials costs on the rise as well, higher labor costs will add more pressure to operating expenses.

Returns. Returns on investment will slow this year as builders face the prospect of rising materials and labor costs. Returns have been especially good in recent years. Above-average returns were fueled by low energy and materials prices. Now that these are normalizing, returns will converge to long-run averages. The construction labor market is remarkably tight, and given capacity constraints in the housing market, wage increases needed to attract additional workers will compress margins. As a result, higher input costs and slower house price appreciation will compress profits for developers over the next few years.

Commercial developers will see higher returns as net absorption rises and vacancy rates fall. While building will be relatively limited, returns on existing properties are poised for a healthy gain as pivotal winemaking and food manufacturing industries jockey for space.

Long-term outlook. With labor shortages increasingly binding, whether residential developers will be able to close the gap with demand remains an open question. Housing loss caused by the Tubbs and Atlas fires has pushed thousands of families into the rental market or out of Sonoma County altogether. The baseline outlook calls for residential construction to accelerate this year and next, but the leveling of a significant share of the county's housing stock will require a sustained increase in construction at above-trend rates to bring supply back in line with demand.

The decline in housing affordability in recent years will loom large. The sharp decline in house affordability since late 2012 has deterred new migrants. This will slow overall population growth and ultimately reduce housing demand. While a tighter labor market will power better wage gains, affordability will deteriorate as house price gains outpace income growth.

A demographic shift is under way, and millennials will soon account for the largest share of first-time homebuyers. Greater student debt burdens and a tendency to postpone homeownership will constrain household formation. This will keep the share of multifamily construction elevated in the long run.

Thriving winemaking, brewing, restaurant and tourism industries confer a positive outlook for commercial real estate. However, as

county vintners, food manufacturers and hospitality operators expand, a lack of available land will apply restraint.

Upside risks. State legislative initiatives to incentivize affordable housing and ease the permitting process lend upside risk to the outlook for residential construction in Sonoma County. California residents will consider a \$4 billion bond issue in November that would fund housing developments for low- and middle-income residents. The bill would also fast-track development of housing units for farmworkers in California's rural areas. County-level efforts to incentivize rebuilding in the wake of the October wildfires, including a local bond issue, could stimulate greater construction and alleviate the shortage of homes for sale. A relaxing of strict building codes in the county's unincorporated areas could stimulate additional construction as well.

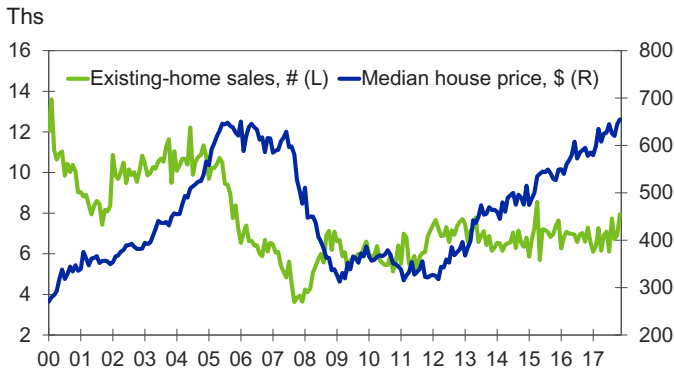
Rising rent and labor costs in other North Bay counties create upside risk for commercial developers in Sonoma County. Low business costs relative to other North Bay counties could entice mid-size tech and financial firms facing cost constraints to relocate, further elevating the outlook for commercial real estate. The biopharmaceuticals corridor in neighboring Marin County is just one example.

Downside risks. The pivotal winemaking and tourism industries will recover, but the loss of several thousand housing units to the Tubbs fire poses considerable downside risk. The shortage of affordable housing posed a formidable challenge before the fires, and the destruction of a large share of the county's housing stock will put continued upward pressure on house prices. A more severe decline in affordability would dent labor force growth and in-migration, which has slowed in tandem with declining affordability. Should homebuilders take longer to replace units lost to the fires, affordability would decline even further.

New tariffs on steel and aluminum imports could cause a faster than anticipated rise in building cost materials. Construction accounts for almost half of total U.S. steel demand, and higher steel prices would raise input costs for builders and weigh on returns. A faster than anticipated rise in short-term borrowing costs poses additional downside risk. A faster rise in interest rates would dampen single-family housing demand in general and deal a setback to first-time buyers, who rely more on mortgage lending.

*Brady Seitz
March 2018*

Prices Recover, but Home Sales Stay Soft

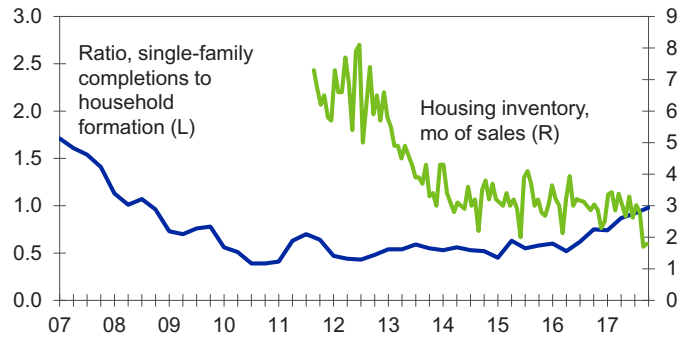


Sources: CoreLogic, California Association of Realtors, Moody's Analytics

After declining in similar fashion following the housing crisis, median house prices have accelerated far more quickly than existing single-family home sales. While house prices have surpassed their prerecession peak, tight inventories have constrained home sales. The low number of listings has kept potential homebuyers on the sidelines, and home sales have struggled to rise from their post-recession nadir. Homebuilding will need to accelerate meaningfully in order to bring supply back in line with demand following widespread housing loss in the Tubbs and Atlas fires.

Homebuilders Struggle to Meet Demand

Housing market tightness indicators, Sonoma County

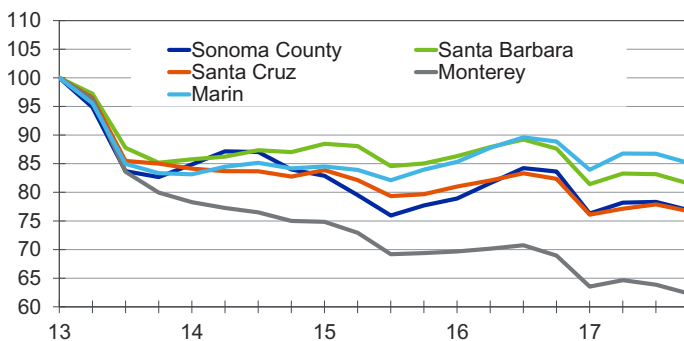


Sources: Census Bureau, California Association of Realtors, Moody's Analytics

There is sustained demand for new housing in Sonoma County. Hampered by worker shortages and rising materials costs, homebuilders have been unable to meet demand in recent years. The housing inventory indicates a need for more stock to balance the market: The pace of single-family completions is badly lagging household formation. It will take several years of above-average growth in construction to bring supply and demand back into balance and alleviate the shortage of single-family listings.

Affordability Declines in Coastal Areas

Composite housing affordability, 2013Q1=100

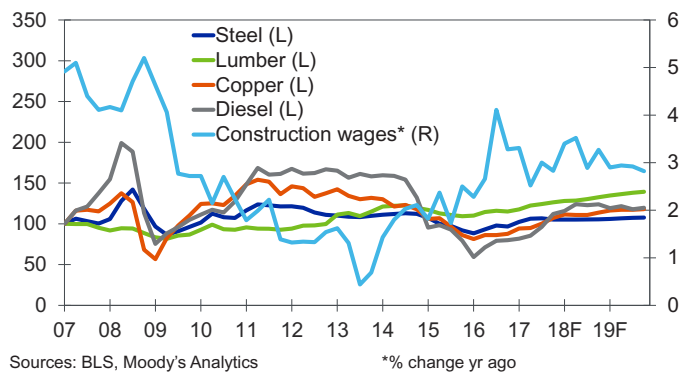


Sources: California Association of Realtors, Census Bureau, Moody's Analytics

Housing affordability will be crucial for Sonoma County's residential real estate market. The October wildfires exacerbated the need to build more affordable units. Median house prices continue to eclipse growth in median family incomes across most of California's coastal and inland metro areas. Sonoma County ranks among the most expensive metro areas in the country. The county's high quality of life and climate make it an attractive destination for potential residents and businesses, though the lack of affordable housing will weigh on in-migration and housing demand.

Labor, Materials Will Be Headwinds

Producer prices, 2007Q1=100



Sources: BLS, Moody's Analytics *% change yr ago

Residential and commercial builders will contend with rising labor and material costs. The shortage of construction workers and the county's extremely tight labor market will push up wages for skilled laborers. Rising diesel prices will also contribute to higher expenses this year and next. All told, rising materials prices will elevate input costs and will weigh on profit margins for residential and commercial developers. However, rising net absorption and low vacancy rates will elevate rents and overall returns on commercial properties.



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