



INDUSTRY INSIDER CONSTRUCTION

INDUSTRY REPORT

2019



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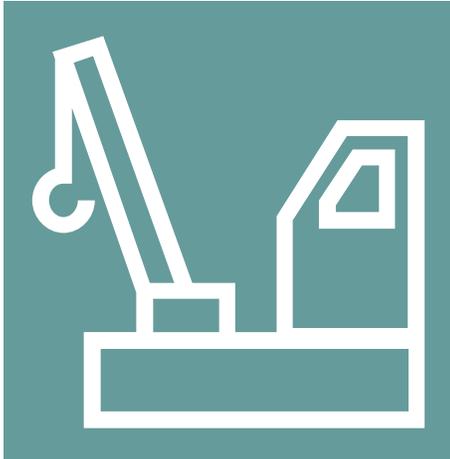


EXECUTIVE SUMMARY

March 2019

The Sonoma County Economic Development Board (EDB), in partnership with the Sonoma County Workforce Investment Board (WIB), is pleased to present the 2019 *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



The primary drivers of the construction industry are housing and commercial real estate. The housing market has slowed down following a post-fire rush, and home sales have significantly declined over the past year as a result of cooling demand. In order for housing to remain a driver of the construction industry, Sonoma County has to continue to issue permits above annual averages over the next several years. Commercial real estate, meanwhile, shows strong growth, though absorption rates fell lightly in late 2018 and retail vacancy rates have increased slowly. Strong expansion in key drivers like winemaking and food and beverage industries drives both industrial and office vacancy rates to near decade-lows.



The decline in housing affordability, one of the most important engines of both rising cost of living and the net loss in migration to Sonoma County, is starting to slow. Nevertheless, Sonoma County remains one of the least affordable places to live, outweighing the benefits of low costs of doing business, natural beauty, and a wide range of recreation opportunities. If the county continues to increase the pace of permitting--which has surged to the highest levels of the last twenty years for both multifamily and single-family homes, as well as nonresidential real estate, and if incomes rise faster than they have, then it is likely that housing affordability will return to more reasonable medians.



Labor costs in Sonoma County, spurred upwards by high cost of living, drives shortages in workforce for construction contractors. For the most part, material costs are holding steady (though this is difficult to predict, given uncertainty at the national trade level). While the statewide trend in affordability begins to slow and may mean lower cost of living in the future, for now, wages for contractors, masons, and other construction laborers are increasing almost as fast as Sonoma County house prices. The EDB, in collaboration with the Santa Rosa Junior College, is in the process of seeking funding for a Construction Training Center that would add supply to the historically tight construction labor market.



Recent Performance. Sonoma County has eased off the gas, but there is little cause for concern. Annual benchmark revisions show the county grew at a more muted pace in 2018 than previously believed, and year-ago job growth fell behind the national average to close out 2018. The labor market is growing increasingly bifurcated, with robust gains among the county's traditional potent drivers, including healthcare, winemaking, and food and beverage manufacturing, outmuscling significant weakness in the public sector. Labor market constraints are undoubtedly weighing on growth. The jobless rate is about equal to its low from the height of the tech boom in the 1990s, while the employment-to-population ratio is at a cyclical high, a sign that slack in the labor market is growing increasingly spare.

The residential real estate market is going through some growing pains, but recent data show the county is heading in the right direction. Housing inventories in terms of months of supply have ticked higher since a mid-2018 nadir, while the ratio of single-family completions to household formation has climbed to its highest level since 2005. Construction payrolls are closing in on their prerecession high, despite significant labor supply challenges.

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. The U.S. housing market hit a bit of a soft patch in the latter stages of 2018. House price appreciation decelerated in each of the last nine months, mortgage purchase applications are flat from their year-ago level, and overall home sales have been trending lower since the start of 2018. Increasing mortgage rates over the year have translated into more elevated housing finance costs and contributed to slower house price appreciation. The 30-year fixed mortgage rate, although still relatively low, trended upward during 2018 before easing slightly at the beginning of the year to 4.8%. Nonetheless, the concerns in the housing market will likely prove a temporary blip. The current housing market troubles are a reaction to a combination of policy tightening and reduced confidence. Mortgage rates will resume rising in 2019 but will no longer pull on house prices as strongly in part because the slowdown in price appreciation will have substantially

reduced the portion of the U.S. housing stock that is overvalued.

The national outlook for home sales is more optimistic. Thanks to slowing appreciation and a steady increase in inventory relative to sales, there will be a slight upward trend in new single-family and condo sales.

The recent pickup in national homeownership rates is a bright light among the recent dour housing figures. While sales and price growth are showing signs of weakness, at the end of the day more households are becoming homeowners. This is true for all age groups, especially the youngest cohort. Improvements in homeownership matter because they suggest that some of the post-recession decline was cyclical, and not entirely structural as some feared. Cyclical forces are greatly preferable, as these should reverse as the economy strengthens. That the homeownership rate turning up over the last two years is a sign of the single-family turnaround is the last part of the recovery to fall into place.

Industry drivers. Sonoma's housing market is still recovering from the damage wrought by the fires. The fires jolted the market, sending prices soaring to an all-time high last June as residents with the means snapped up available inventory. Prices have since slid as demand cooled following the post-fire rush, and a lack of available homes and prohibitively expensive houses weighed on purchasing decisions. House prices in Sonoma County retreated for most of last year following a surge at the start of the year. Home sales tell a similar story. After peaking in January 2018 to reach a five-year high, home sales cratered to their weakest three-month stretch in eight years. Slowing house price appreciation and significant efforts to replenish the housing stock are welcome sights. Permit issuance throughout 2018 was three times higher than a year prior, and prices are set to increase only modestly over the next year.

The rebuilding process will take some time, and the road will be bumpy. Although labor shortages plague most industries, skilled construction trades workers are arguably the hardest to find. As evidence that local workers are difficult to find, average weekly pay for construction workers through the second half of 2018 rose at nearly twice the national rate. Offsetting some of this pressure on construction companies is the flattening of material costs, which had surged through the first six months of 2018 before moving sideways since then. Fuel costs will rise only marginally higher through the end of the decade as well.

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.

Affordability is forecast to decline only modestly through the end of the decade as house price appreciation slows to a more modest pace and income growth finds another gear. Yet Sonoma will still rank as one of the least affordable metro areas in the nation.

Housing demand drivers are still strong, but a slowdown in in-migration due to a lack of affordable housing would deal a double whammy to both the housing and labor markets.

The commercial real estate market is on firm footing. Net absorption of office space continues to rise, and falling vacancy rates have spurred new construction. Industrial space is more readily available than office space. Absorption rates fell slightly through the fourth quarter of 2018 after rising at their fastest pace in nearly two decades through the start of 2018. Still, Sonoma's robust job market, and in particular growth among its key drivers in the winemaking and food and beverage industries, will support demand for industrial space. Vacancy rates are still near decade-lows, and developers are taking full advantage.

Retail vacancy rates have slowly increased from their low in mid-2017, but the market overall remains buoyant. The departure of Sears in late 2018 is more of an indictment on the department store chain itself, which has been floundering and shuttering stores nationwide over the past few years. Growth in experiential retail such as restaurants, brewpubs, and local craft shops will underpin demand for retail space even as big-box retailers ease off the gas.

Short-term pricing. The tight inventory of existing homes for sale will strengthen homebuilders' pricing power in the near term. However, as the housing market rebalances and residential construction accelerates, house price appreciation will settle into a more modest pace compared with the robust growth over the past few years. Having surged past their prerecession peak, house prices will move roughly in line with the national average in the coming quarters. As more young and first-time homebuyers enter the market, the mix of home sales will begin to swing

toward smaller and affordable properties, lowering prices for builders.

Record low vacancy rates will push prices up for multifamily projects. Apartment rents will rise less quickly over the next year after residents who lost homes either leave the county or find new homes. However, rents will remain elevated as the improving economy enables more college graduates and young adults to strike out on their own. As the backlog of multifamily projects is lengthening, strong demand will safeguard pricing power.

Prices for commercial properties will ascend further this year as growth in food and beverage manufacturing and tourism underpins industrial and retail demand. Even with a flurry of new hotel openings in the pipeline, occupancy and average daily rates continue to climb as Sonoma welcomes more new visitors. The office market is less tight, and lower absorption and greater availability of space will limit pricing power.

Operating expenses Commercial and residential builders will face rising costs this year as growing labor expenses outweigh the respite from stabilizing commodity prices. Lumber, steel and copper prices have been volatile over the past year, and uncertainty regarding the U.S. trade policies led to significant price fluctuations through 2018. 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. Anecdotally, Sonoma builders are competing for housing materials, including soft woods, with other fire-ravaged regions in the state. This is consistent with more lagged data from the Quarterly Census of Employment and Wages suggesting that labor costs are rising. 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 the combination of rising construction wages and input costs coupled with slowing house price appreciation weighs on margins. Returns have been especially good

in recent years, fueled by low energy and materials prices. However, now that these are normalizing, returns will likewise converge to long-run averages. A historically tight labor market for construction workers will necessitate further wage increases to attract additional workers, which will compress margins.

Commercial real estate will likely enjoy another strong year through 2019. With the vacancy rates for industrial and retail properties just a few basis points off their historic lows, and nearly half of what is considered a balanced market, commercial developers stand to benefit as fast-expanding food and beverage makers and hospitality operators jockey for new and existing commercial space. Still, rising labor costs will chip away at returns even in light of robust demand and rising rents.

Long-term outlook. Sonoma's residential and commercial real estate markets share an optimistic long-run outlook, but low housing affordability will pose serious concerns. Net-migration has slowed substantially over the past four years, coinciding with a swift erosion in housing affordability. While the deterioration in affordability is forecast to slow over the next couple of years, Sonoma will remain one of the least affordable destinations nationwide. Lower in-migration would sap housing demand, and hamper Sonoma's ability to outrun labor market constraints.

The baseline outlook calls for residential construction to accelerate through this year, and for the housing market to navigate the post-fire turbulence gracefully, but any slowdown in rebuilding efforts may dissuade Sonoma residents from returning to the area longer term.

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 recent improvement in the national homeownership rate suggests that this is already happening.

The feverish pace of expansion at local food, beverage, consumer goods and hospitality operators will create fertile ground for commercial developers. However, the construction of new office buildings will pro-

ceed at a more modest pace as office-using industries expand into existing space.

Upside risks. Improved housing affordability as a result of more modest house price increases, faster income gains, or more rapid rebuilding efforts 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, and should affordability slow or even improve, migration patterns may tilt in the county's favor once again.

Statewide legislative initiatives to incentivize affordable housing developments would prove especially beneficial to Sonoma. County stakeholders have already expedited the permitting process and lowered the associated fees for smaller units, but further efforts to encourage more affordable developments at the state level 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.

Downside risks. Though the trade war rhetoric has cooled off in recent months, protectionist policies from the Trump administration still have the potential to disrupt Sonoma's commercial real estate market. A meeting in November between President Trump and Chinese President Xi Jinping yielded a temporary truce in hostilities. However, if no deal is reached this year, the U.S. may further ratchet up pressure on China by increasing tariffs on about \$200 billion in Chinese goods. 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 as well. First-time and returning buyers would bear most of the burden, and the resulting slack in purchase demand would sap the housing recovery's momentum.

*Colin Seitz
March 2019*

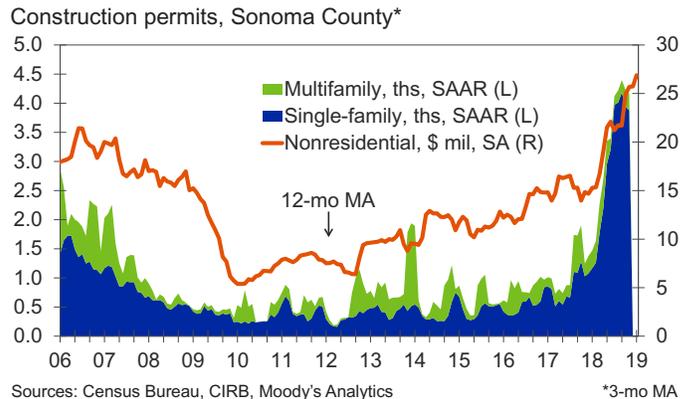
Prices Slip and Home Sales Stay Soft



Sources: CoreLogic, California Assn. of Realtors, Moody's Analytics

Despite the swift acceleration in house prices, existing-home sales have been a stubborn laggard in the post-recession years. Housing inventory in terms of months of supply is still tight, and the sparse selection of existing homes for sale has put a serious damper on homebuying. Fortunately, with more supply in the pipeline and an acceleration in wage growth, home sales will find another gear over the next year.

Permit Issuance Surges Across the Board

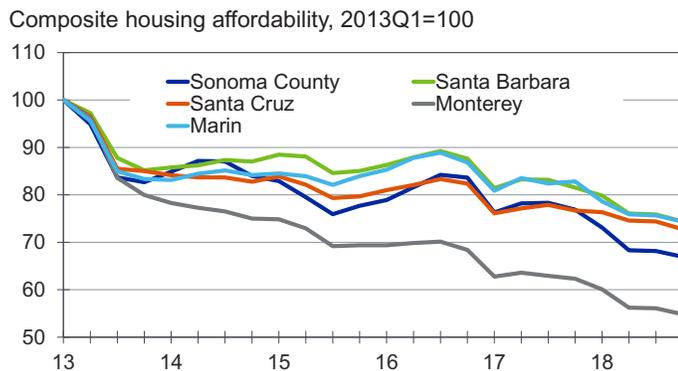


Sources: Census Bureau, CIRB, Moody's Analytics

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Residential and commercial builders in Sonoma County closed out 2018 with a rapid increase in activity, blowing past the pace seen in any year since the recession. Rebuilding efforts and a concerted effort to fast-track the permitting process have been crucial developments. The ferocious pace of expansion among winemakers, food and beverage producers, hospitality operators, and retailers has pushed vacancy rates down and will support new commercial construction.

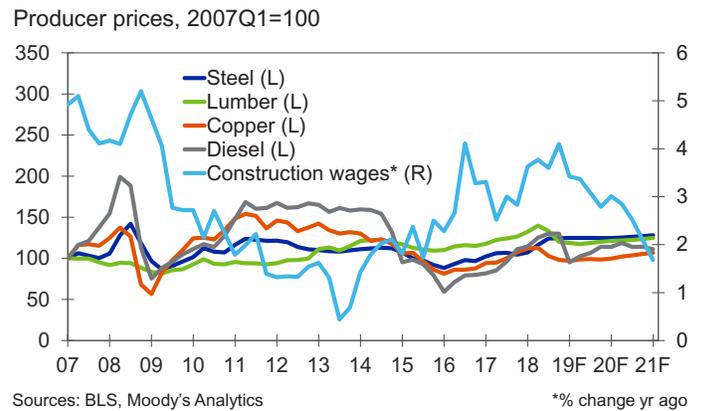
Affordability Declines Begin to Slow



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

Housing affordability remains the key challenge facing 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 midsize 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 the levels of previous expansions.

Labor Costs Surge, Materials Hold Steady



Sources: BLS, Moody's Analytics

*% change yr ago

Residential and commercial builders will contend with rising labor costs, but only modestly rising material costs will ease the pain. The shortage of construction workers in the county's extremely tight labor market will push up wages for skilled laborers. After a sharp decline at the start of this year, rising diesel prices will also contribute to higher expenses. Despite elevated input costs, rising net absorption and low vacancy rates will elevate rents and overall returns on commercial properties.



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