



CONSTRUCTION

INDUSTRY INSIDER

2022



ECONOMIC DEVELOPMENT BOARD

BOARD OF DIRECTORS

KATHRYN HECHT, CHAIR JORGE ALCAZAR SKIP BRAND BETZY CHÁVEZ
 LINDA KACHIU JORDAN KIVELSTADT WAYNE LEACH REGINA MAHIRI
 RICHARD MARZO MICHAEL NICHOLLS
 ETHAN BROWN, Interim Executive Director

EDB FOUNDATION SPONSORS

FOUNDATION LEVEL



Luther Burbank®
Savings

PRESENTING LEVEL



PREMIERE LEVEL



EXECUTIVE LEVEL

- COMCAST
- NORTH BAY ASSOCIATION OF REALTORS
- PISENTI & BRINKER LLP
- SUMMIT STATE BANK

SONOMA COUNTY BOARD OF SUPERVISORS



CONTENTS

- 4. EXECUTIVE SUMMARY
- 6-8. MOODY'S INDUSTRY ANALYSIS



EXECUTIVE SUMMARY

August 2022

The Sonoma County Economic Development Board (EDB), in partnership with the Sonoma County Workforce Investment Board (WIB), is pleased to present the 2022 *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.

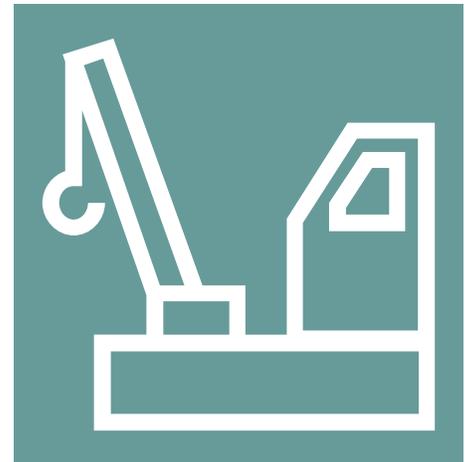
HIGHLIGHTS



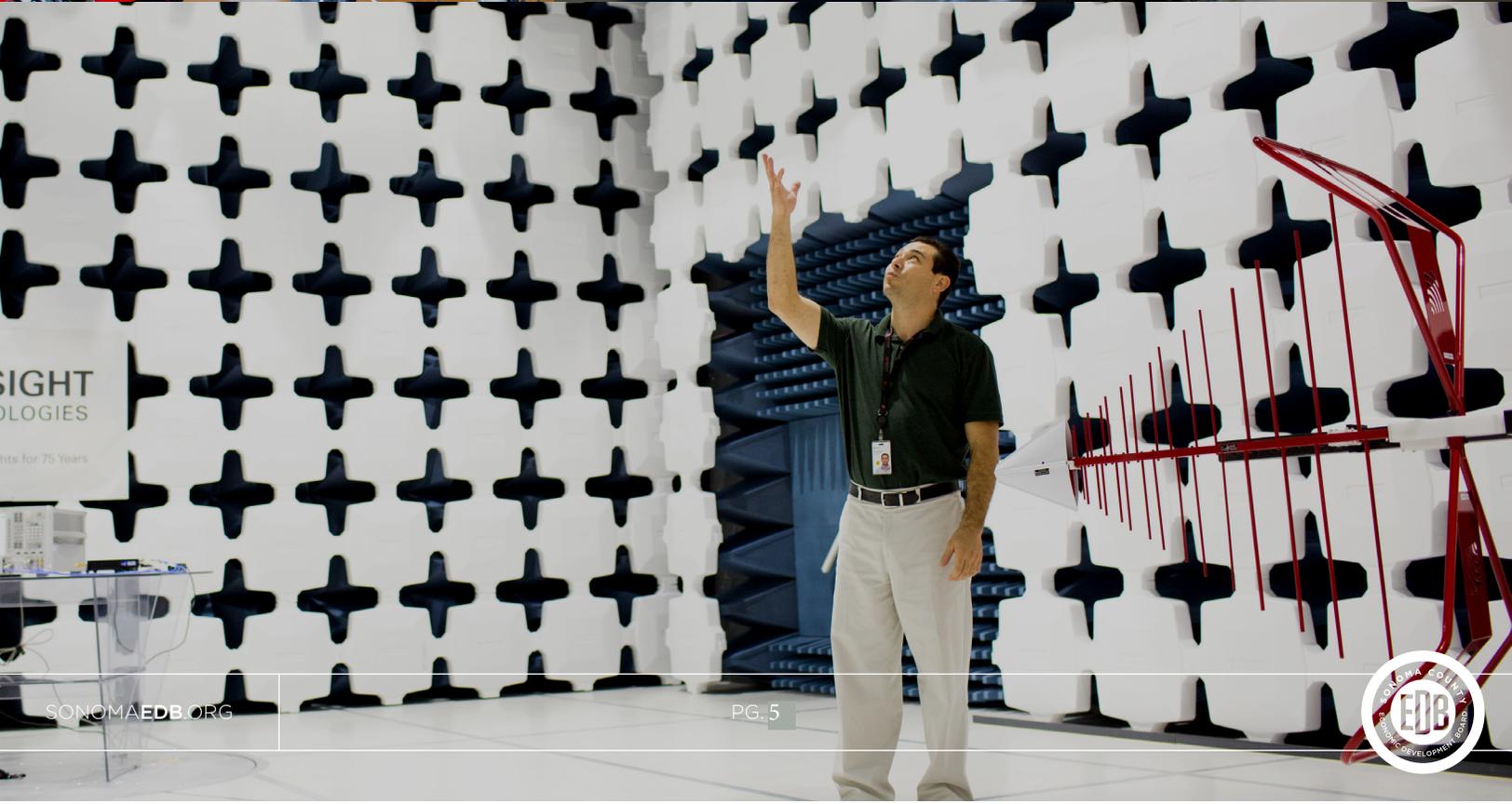
Despite devastating wildfires and disruption by the global pandemic, the housing market in Sonoma County proves resilient. Supply concerns have been slightly eased by the rebuilding efforts following the Tubbs and Kincade Fires. The county has rebuilt nearly all of the housing destroyed in these natural disasters. However, the supply gap caused by years of underbuilding will persist into the future. The next several quarters will face high costs of building inputs including land, labor, and materials. Nationally, there were 1.9 million annualized units authorized in January reflecting builders' confidence. An 11% increase in multifamily permits in the past year may be driven by high energy prices and a resulting demand for less car-dependent and higher density housing options.



The residential real estate market hit an exceptionally high appreciation rate in mid-2021. While that pace has slowed slightly, it remains high, above 10% year over year. While multifamily permit issuance is growing at a pace around three times the pace of the previous five years, single-family permit issuance has remained similar. With a record low number of home listings for sale, it is a difficult situation for buyers, especially those looking for single-family units. Income growth is predicted to remain strong this year and help to make up for the high costs of housing. Mortgage rates should also remain below the long-term average for the next few years. Sonoma will remain one of the most expensive places in the nation, but one of the least expensive in the Bay Area.



The commercial real estate market has recovered well from the pandemic. Quarter three of 2021 was its strongest quarter in 15 years. However, the office market suffers as more companies shift to long-term remote work plans. The retail industry has shown signs of recovery, with vacancy rates improving over the last three quarters. Additionally, retail markets should see an improvement as consumers begin to spend excessive savings accrued over the pandemic. The industrial market stands out from the rest with levels of vacancy lower than pre-pandemic levels due to an uptake in e-commerce and nationwide goods purchases. Rapid expansion of local food, beverages, consumer goods and hospitality will aid commercial development in the area.



Recent Performance. Sonoma County's economy is once again pressing on the accelerator and making up ground on California and the U.S. Payroll growth has outstripped the national pace by a comfortable clip over the past year, but a steeper initial drop in payrolls still leaves the county further from recouping its pandemic-related job losses; payroll employment is down 4.9% from February 2020, compared with 1.8% for the U.S.

Leisure/hospitality has made significant progress in recent months, but the industry remains the hardest-hit by the pandemic and payrolls are 15% below pre-virus levels. Manufacturing was quicker to recover, but its growth has stalled since the initial recovery. Construction, meanwhile, is one of the metro area's best-performing industries. Job growth has surged since the middle of 2021, and payrolls have blown past their pre-COVID-19 levels.

The residential real estate market held up remarkably well during the initial stages of the pandemic and remains in good shape. House price appreciation has cooled slightly from its breakneck pace during mid-2021 but is still surging at more than 10% year over year. While still strong by historical standards, it trails the national pace of nearly 20%. The prevailing dynamic is one of strong buyer demand competing for an inadequate inventory of listings for sale. According to the California Association of Realtors, both the number of homes selling above listing price and the median days on market are nearing historical levels. Despite record-low inventories and strong demand, single-family permit issuance has held mostly steady over the past two years while the multifamily segment is on pace for its strongest year in decades, surging at nearly triple the pace of any of the previous five years.

The commercial real estate market rebounded strongly in the second half of 2021. Nonresidential permit issuance surged in the third quarter, posting its strongest quarter in 15 years. After rising in mid-2020, both the office and retail segments have seen their vacancy rates hold roughly steady as COVID-19 continued to linger and nonessential business closures, contagion fears, and work-from-home arrangements remained commonplace for much of the past year and a half.

Macro drivers. Housing demand drivers are set to improve this year. The labor market has been revving higher in recent months, and employment is poised to retrace its pre-pandemic level in the second half of this year. A record-high level of job openings and new expansion plans by businesses also bode well for contin-

ued labor market strength. In addition, income growth, which will remain robust this year, will help to offset the decline in affordability driven by higher house prices. Moreover, although they are set to increase over the next couple of years, mortgage rates will remain below their long-term average.

Rock-bottom housing supply will remain a problem for potential homebuyers in 2022. The number of existing-home listings cratered to 860,000 units in January, another record low going back to 1999. In addition, months' supply of homes at the current pace of sales also registered an all-time low of 1.6 months in January, signaling the market's extreme tightness. Home sellers are poised to continue to take advantage of the lack of supply by raising prices. Existing-home sales will remain approximately flat at around 6 million units in 2022, down slightly from 6.1 million units in 2021.

Further, although single-family construction activity remains above its pre-pandemic level, previous years of underbuilding indicate that the supply gap will persist for some time. Difficulties in obtaining land, labor and materials at reasonable prices will only compound the supply-side challenges in the new-home market for at least the next several quarters. As a result, new-home sales fell nearly 20% from a year earlier to 800,000 in January.

Builder confidence remains strong with the National Association of Home Builders' Housing Market Index virtually unchanged from last year's level. Applications for housing permits reflect builders' enthusiasm with 1.9 million annualized units authorized in January. Demand remains concentrated in the single-family sector with more than 1.2 million permits issued. Affordability concerns may partially explain the nearly 11% increase in multifamily permits over the past year. Higher energy prices may drive demand for smaller, higher-density, less car-dependent housing.

House prices will extend their upward trend in 2022, driven by a combination of limited supply and steadily rising demand, though the pace of growth will be slower than in 2021. Growth is already decelerating in many markets. The FHFA Purchase-Only Home Price Index was up 17.5% year over year in the fourth quarter, down from 18.6% in the third quarter.

Houses are quickly growing overvalued, according to the Case-Shiller trend equation. The national level stands at 27% after starting 2021 at just 8.5%. This is inching closer to the 35.2% rate of overvaluation right before the onset of the housing bust back in

early 2007. However, this is not an immediate cause for concern. Lending standards and income requirements for borrowers have remained relatively stringent through the worst of the pandemic, so the risk of an extended downturn in house prices is lower.

Demand for certain segments, particularly office structures, is unlikely to be clear until workers can safely return. Return-to-office plans vary significantly by region, but according to WFH Research, nearly 40% of paid full days are still remote. From there, many individuals and companies that have transitioned to a remote work environment in the past year may continue to do so, crimping demand for new office investment longer term.

Industry drivers. Sonoma County's housing market proved resilient in the wake of years of devastating wildfires and the disruption caused by shelter-in-place orders amid the global pandemic and is poised for another strong year in 2022. Significant rebuilding efforts following the Tubbs Fire and to a lesser extent the Kincadee Fire over the past few years have eased supply concerns, and the county has recouped nearly all the housing units lost to the natural disasters. However, years of underbuilding prior to the pandemic, coupled with exceptionally strong demand over the past year, has once again dwindled the available pool of homes. Single-family permit issuance cooled through 2020 and 2021 as these rebuilding efforts wound down but was still nearly twice as strong as in 2017.

As a result, affordability is forecast to decline through the end of the decade, though it will still not reach levels seen in the runup to the housing crisis. House price appreciation will slow to a more modest pace and income growth will find another gear as the economic recovery gathers momentum, slowing the decline in affordability. Yet Sonoma will still rank as one of the least affordable metro areas in the nation, though it will remain among the most affordable in the Bay Area.

In 2020, the last year for which data are available, the county's population fell by 0.5%, marking the fourth straight year of declines, though this marked a significant deceleration from the declines in 2018 and 2019. Previous research by Moody's Analytics sought to separate the effects of natural disasters from affordability in determining net migration and found no statistically significant impact of wildfires on net migration in California. Although it is naive to assert that two significant wildfires in three years will have no

impact on Sonoma's population growth, there is little empirical evidence to suggest that they will prove meaningful drivers of demographic trends. Instead, broader macroeconomic factors such as costs and availability of jobs and more qualitative considerations such as weather and quality of life are more predictive of population growth—and consequently, economic potential—in the long run.

The commercial real estate market is more of a mixed bag. According to Keegan & Coppin, vacancy rates across property types are now holding steady after an initial rise early in the pandemic. The proliferation of e-commerce helped buoy industrial property demand, but at the same time chipped away at retail, which was already being pressured prior to COVID-19. Retail vacancy rates have shown some signs of improvement over the last three quarters and boast a more optimistic outlook than the office market as more companies commit to long-term remote work plans.

The industrial market is the standout, with vacancy rates already below their pre-pandemic levels. The surge in e-commerce and nationwide goods purchases is likely to slow as spending shifts more to services that have been unavailable for the last two years. Yet the county's collection of food and beverage manufacturers will keep vacancy rates steady. Nonresidential permit issuance had its best quarter on record in the third quarter of last year, but a slight slowdown in the industrial market will keep it from reaching those heights through 2022, despite more support from the retail and office segments.

Short-term pricing. The main challenges facing homebuilders are rising costs and affordability issues, which will begin to chip away at homebuilders' pricing power. Strong demand will allow builders to still raise prices, but the retreat in house price appreciation nationally and in the county gives evidence that many millennials looking for entry-level homes may not be able to afford the higher-priced new homes.

Prices for commercial properties will be mixed but will generally improve as firms grow more certain about the trajectory of the U.S. economy. Many expansion plans were postponed or delayed at the outset of the pandemic, but with the national economy expected to surge this year, vacancy rates across property types will decline and prices will rise. Retail will be the slowest to recover. Vacancy rates were already rising prior to the pandemic, and retailers are being pressured by the rise of e-commerce.

Operating expenses. Commercial and residential builders will contend with higher commodity prices and labor expenses. Robust demand for workers will increase wage pressures for construction workers. Construction wages in Sonoma are ticking higher, though the pace is slightly behind what was seen in recent years. It will accelerate as builders attempt to bridge the supply gap.

Scarce resources continue to boost costs and increase building times. Desirable lots in high-demand areas are limited, while finding enough construction workers can be difficult and slow the pace of projects. Additionally, the recent jump in oil prices only accelerates price growth. Higher oil prices feed into the cost of transporting large construction materials. Moody's Analytics expects that West Texas Intermediate oil prices will reach their average quarterly peak at \$100 per barrel next quarter. The anticipated increase in global supply over the year will be enough to move prices lower from their current highs.

Returns. The economic recovery will see upward real estate price pressure as material costs climb, but across the country the former will predominate in terms of near-term profitability. Returns had been especially good prior to the pandemic, fueled by low energy and materials prices. However, as the expansion aged and labor costs rose, returns were already beginning to tighten and converging to long-run averages.

With the economy set to rev up this year, strong demand for both commercial and residential properties will exert upward price pressure that will ensure near-term profitability. House price appreciation will slow from last year's breakneck pace but will remain robust. Thus, construction returns will move in tandem with house prices.

Long-term outlook. The long-run outlook for Sonoma's residential and commercial real estate markets is sanguine. The COVID-19 pandemic created a much smaller disruption to the housing market than first anticipated, but demographics will play a far more important role in the long term.

Net migration has slowed substantially over the past four years, coinciding with the swift erosion in housing affordability. The deterioration in affordability is forecast to slow over the next couple of years, and with house prices expected to advance modestly over the next year, affordability will hold up better in the medium term. Still, Sonoma's coastal location in high-cost California ensures that it will remain one of the least affordable destinations nationwide.

Population growth is expected to remain weak but strong enough to support a modest rise in housing starts even after rebuilding efforts are completed. Lower in-migration would sap housing demand and hamper Sonoma's ability to outrun labor market constraints.

The changing of the demographic guard is at hand, and millennials are diving into homeownership as they age into having families. Better income gains and improved job prospects will stir even more young households to plunge into homeownership. This will boost home sales and new construction.

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 proceed at a more modest pace as office-using industries expand into existing space and the acceptance of remote work chips away at some demand for office space. Retail will improve slightly. Retail sales will increase as pent-up demand and excess savings are unleashed but the proliferation of e-commerce will limit the need for physical retailers.

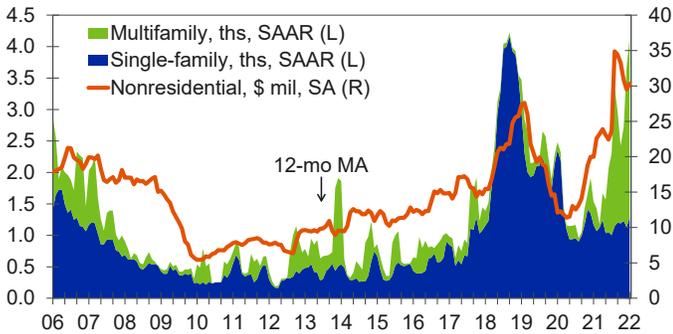
Upside risks. Stronger-than-expected population growth should more Bay Area residents move to the more spacious Sonoma County region provides significant upside risk for the housing forecast. The county's natural beauty, abundant outdoor recreation opportunities, proximity to the Bay Area, and relatively low business costs make Sonoma attractive to potential residents, and should affordability improve, migration patterns may tilt in the county's favor once again. Improved housing affordability as a result of more modest house price increases, better-than-expected income gains, or more rapid rebuilding efforts is the primary avenue through which residential construction could surprise to the upside.

Downside risks. Rising long-term interest rates could create problems for corporations and the real estate market. Nonfinancial debt and loans sit near record-high shares of GDP, and higher rates will significantly increase borrowing costs for highly indebted corporations, many of which are still struggling from the pandemic, and households, taking the wind out of the housing market. A string of corporate defaults or a significant widening of corporate bond spreads could dampen investor sentiment and soften investment. This would deal a blow to the county's construction industry, with a pullback in business expansions.

Colin Seitz
March 2022

Real Estate Market Is Very Strong

Construction permits, Sonoma County, 3-mo MA



Sources: Census Bureau, CIRB, Moody's Analytics

After a brief lull at the height of the pandemic, residential and nonresidential permitting is strong again in Sonoma County. The pace of single-family permit issuance is below that seen in 2019 as the rebuilding efforts from the Tubbs Fire are largely complete, but multifamily permit issuance is surging and the value of nonresidential permitting is only a touch off its record high. With house price appreciation skyrocketing, permit issuance is expected to climb higher through 2022.

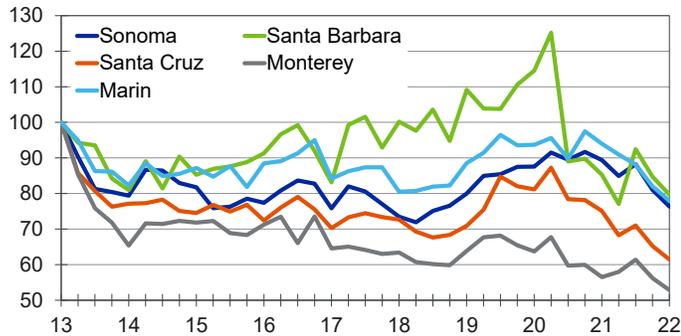
Prices and Home Sales Recover Swiftly



Home sales have recovered following their initial decline during the onset of the pandemic. Red-hot housing demand is propping up sales, but a lack of available homes and surging house price appreciation are causing some would-be sellers to hold on to their properties. Median house prices are now 30% higher than their pre-housing crisis level. Demand-side housing drivers are set to improve this year, and years of underbuilding will ensure that house prices continue to rise in the near term.

Affordability Declines Will Persist

Composite housing affordability, 2013Q1=100

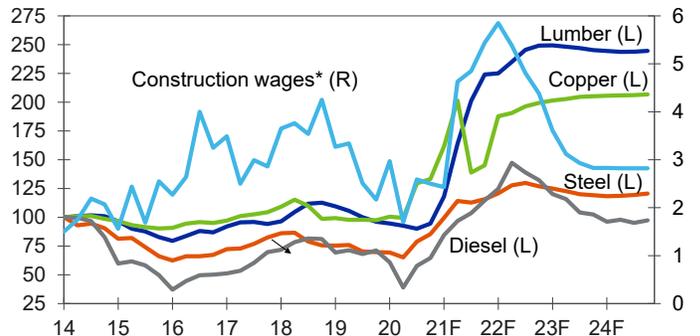


Sources: California Assn. of Realtors, Census Bureau, Moody's Analytics

Housing affordability remains the key challenge facing Sonoma County's residential real estate market. Rapid house price appreciation over the past year has eroded the progress made prior to the pandemic. The county's high quality of life and relatively low business costs make it attractive to potential residents and entrepreneurs. On the plus side, house price appreciation is forecast to slow over the next year, and the slowdown in affordability increases could help stem the tide of out-migration and outright population declines, which have become the norm in recent years.

Input Costs Rise Across the Board

Producer prices, 2014Q1=100



Sources: BLS, Moody's Analytics

*% change yr ago

Residential and commercial builders will grapple with rising commodity prices and increasing wage pressures. The economic recovery and red-hot housing market will increase labor market tightness for construction workers and push up prices for housing materials. Construction wage growth is already near its record highs. Furthermore, Russia's invasion of Ukraine and supply-chain disruptions have caused a surge in commodity prices that will take some time to unwind.



SONOMA**EDB**.ORG

707 - 565 - 7170

141 STONY CIRCLE, STE.

SANTA ROSA, CA 95401