



CONSTRUCTION

INDUSTRY INSIDER

2021



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EXECUTIVE SUMMARY

June 2021

The Sonoma County Economic Development Board (EDB), in partnership with the Workforce Investment Board (WIB), is pleased to present this 2021 Local Industry Insider Report. For additional information, questions, comments, or suggestions, please contact us at (707) 565-7170 or visit www.sonomaedb.org.

Disclaimer to the Reader: *The forthcoming details in this report reflect trends sourced from data gathered during the novel COVID-19 pandemic. Figures, such as employment rates, have been susceptible to great variability and are ever-changing.*

HIGHLIGHTS



Real Estate Market:

Sonoma County's construction industry has managed the trouble of the pandemic better than most industries. On an annual basis, Sonoma County construction job losses are five percent less than the losses spread across total employment. The relative success has been supported by the residential real estate market. Sonoma County house prices continue to rise at the fastest pace in over two years as demand outpaces supply; despite single family permit issuance still being nearly double what it was in 2017. This surge in demand is likely coming from the following: the increase in remote work, proximity to the Bay Area, and relative affordability among Bay Area counties.



Labor Force:

With construction payrolls being relatively successful during the COVID-19 pandemic, the demand for the construction workforce is expected to continue well after. Though it is expected for there to be job opportunities in the industry, employers may have trouble acquiring an adequate workforce. The potential trouble is twofold, and are not mutually exclusive. The first reason is housing affordability and the second reason is the demographics in Sonoma County shifting toward an aging population. Both of these challenges pose potential threats to securing a willing and able workforce for the construction industry.



Construction Costs:

Builders are experiencing higher commodity and labor expenses. Though construction labor wages plateaued in mid-2020, they are expected to accelerate as residential building ramps up and competition for an adequate workforce rises. Other input costs are on the rise as well. Most notably, Lumber prices are likely to continue going up until there is an end to the COVID-19 induced supply shocks; the same holds true with copper, steel and fuel prices. Despite the short term increases in input costs, it is likely that short term returns on construction will be strong and will likely move steadily with home prices.



Recent Performance. Sonoma County's economy has taken its foot off the gas. Following a steep drop in December, job gains through the first two months of the year have been minimal, pushing year-ago job growth further behind the California average. The chief culprit was the reimposition of business restrictions given rising COVID-19 case counts throughout the state. Sonoma remained in the state's most restrictive purple tier through the beginning of March, but case and test positivity rates have fallen sharply, allowing the county to move into the less restrictive red tier on March 14. This allows the county's retail and leisure/hospitality establishments to open in-doors at limited capacity.

As expected, leisure/hospitality is the worst-performing industry, with payrolls down nearly 40% from year-ago levels. While still struggling, goods producers are broadly faring better than service providers. Construction in particular has held up well given the strength of the housing market. Payrolls are down just 8% on an annual basis, compared with nearly 13% for total employment.

The residential real estate market held up remarkably well during the initial stages of the pandemic and remains in good shape. House price appreciation is advancing at its fastest pace in more than two years and sits neck and neck with the California average. According to the California Association of Realtors, housing inventories in terms of monthly supply are at just less than three months, on par with the July 2018 low. Single-family permit issuance showed signs of accelerating late in the year, but has since retreated. Nonetheless, it remains above its historical pace as the fire rebuilding phase winds down.

The commercial real estate market is bifurcated. Vacancy rates have ticked higher, especially in the most affected retail market. There are still signs of life, however. The value of nonresidential permitting surged in the fourth quarter, registering its best performance since mid-2018.

Macro drivers. National house price appreciation will extend into 2021, although it will cool somewhat from its breakneck pace in 2020. The aggregate CoreLogic Case-Shiller price index will grow by 5.6% in 2021, bolstered by consistently tight existing-home supply. Nonetheless, there will be some moderation on the demand side, as financing costs are increasing. For example, the 30-year fixed mortgage rate will advance to 3.7% by the end of 2021 and 4.1% by the end of 2022

U.S. house prices are only moderately overvalued, according to the Case-Shiller trend equation, at 8.5%, a far cry from the 35.2% rate of overvaluation before the onset of the housing

bust in early 2007. In addition, lending standards and income requirements for borrowers have remained relatively stringent through the worst of the pandemic, so the risk of a downturn in house prices is lower.

The lack of existing-home supply available for potential homebuyers will remain a weight as the dearth of selection begins to eat away at sales. Seasonally adjusted existing-home inventory fell to 1.12 million units in February, its lowest level in more than 20 years. Although the inventory-to-sales ratio improved slightly as a result of a drop in sales, at two months of supply at the current pace of sales, it is hovering near a record low. Moreover, even as new-housing construction streamed higher in 2020, it has given up gains in the opening months of 2021 and has thus far been insufficient to relieve the supply challenges in the existing-home market.

Despite higher rates and constricted supply, existing-home sales will advance slightly in 2021 as the broader economy accelerates in the second half of the year. Vaccine distribution is picking up the pace, and as herd immunity is reached in mid-2021, consumer confidence will rebound. Generous fiscal stimulus will also course through the economy, bolstering the labor market and income in coming quarters.

Consequently, existing-home sales will end the year at around 1.4 million units, up modestly from the 1.2 million units registered at the end of 2020.

Demand for certain segments, particularly office structures, is unlikely to be clear until workers can safely return. 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. The infrastructure plan results in a stronger economy over the coming decade, with higher GDP, more jobs and lower unemployment. However, the most immediate impact in early 2022 is to marginally reduce growth, as the higher corporate taxes take effect right away while the increased infrastructure spending does not get going in earnest until later in the year. This changes quickly. By 2023 and throughout much of the middle part of the decade the ramp-up in infrastructure spending significantly lifts growth. The apex in the boost to growth from the plan is in 2024 when real GDP is projected to increase 3.8%, compared with 2.2% if the plan fails to become law. In terms of jobs, with the infrastructure plan the economy recovers the jobs lost in the pandemic recession by early 2023, not much different from without the plan. But the plan does result in substantially more jobs mid-decade, with employment under

Biden's term as president increasing by 13.5 million jobs. This compares with 11.4 million jobs without the plan, and 10.5 million if neither the infrastructure plan nor ARP had become law. Unemployment is also meaningfully lower with the plan, falling to a low of 3.5% by the end of 2024, consistent with the low reached just prior to the pandemic. Labor force participation is also expected to fully recover from the impact of the pandemic by the end of 2024.

Industry drivers. Sonoma County's housing market has proved resilient in the wake of years of devastating wildfires and the disruption caused by shelter-in-place orders amid the global pandemic. Significant rebuilding efforts following the Tubbs wildfire 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. Permit issuance cooled again in 2020 as these rebuilding efforts wound down but was still nearly twice as strong as in 2017. Still, demand is surging, partly because of the proliferation of remote work, which is drawing more residents to Sonoma, given its high quality of life and proximity to the Bay Area economies. Available inventory is being whittled down, with the National Association of Realtors reporting just over two months' worth of supply at the existing pace of sales, the lowest level since the post-Tubbs fire rush.

Though a pickup in construction coupled with a retreat in household formation has meant that single-family housing completions have caught up to household formation, it will take a few 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 despite remaining among the most affordable in the Bay Area.

In 2019, the last year for which data are available, the county's population fell by 0.9%, marking just the fifth decline since tracking began nearly a half century ago and by far the sharpest drop in that period. 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 naïve 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, 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. There is some upside risk that the shift to remote work may benefit Sonoma, given its amenities and proximity to the Bay Area.

The commercial real estate market is more of a mixed bag. According to Keegan & Coppin, vacancy rates across property types have ticked higher during 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. Office vacancy rates rose modestly as well. Moody's Analytics expects office vacancy rates to improve as Sonoma moves into the red tier. Vacancy rates across property types will likely improve as the vaccination rollout accelerates and the economy marches into recovery. Firms will look to capitalize on the rip-roaring growth as consumers unleash pent-up demand over the next few years, and with more economic certainty, expansion plans that were put on hold will push forward. The biggest boost to spending goes to traditional infrastructure, including transportation projects such as roads, bridges and ports, and to shore up the nation's crumbling water and power infrastructure. These projects will spur construction spending and employment nationally as government spending is distributed to the private sector through grants and partnerships.

Short-term pricing. Homebuilders' pricing power will remain strong in the near term, buoyed by ultra-low mortgage rates and the release of some pent-up demand for residents that have been cooped up for nearly a year because of the pandemic. Historically low inventories that have propped up house prices this year will encourage more homebuilding and will slowly erode at pricing power as supply catches up to demand.

Apartment rents will modestly retreat as the moratorium on evictions and the pause of rental payments due to the pandemic are lifted, which will temporarily push up vacancy rates and chip away at demand. While rents submarined in the Bay Area during the pandemic as some workers left the area, Sonoma's declined only modestly, roughly on par with the national average, despite its high costs. Rental vacancies statewide are forecast to increase moderately through the end of this year, which will further pressure rents lower until the economy kicks into another gear.

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 during 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 had paused in the second and third quarters of 2020 following strong growth in previous years. With residential building set to accelerate, construction wage growth will accelerate again.

Commodity prices are already hitting another gear as the global economy heats up. Lumber prices, in particular, are surging, and the forecast calls for continued growth until COVID-19-related supply shocks are unwound.

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 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 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.

Upside risks. The newly passed fiscal stimulus bill will pave the way for a faster than expected economic recovery, and the American Jobs Plan specifically provides significant upside risk for the construction industry. The infrastructure package is larger than that assumed in the March baseline forecast and lends significant upside to construction spending over the next several years if passed.

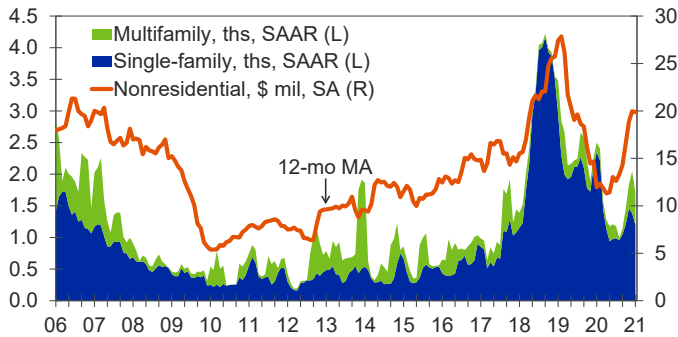
Stronger than expected population growth should more Bay Area residents move to the more spacious Sonoma County region provides significant upside risk for the housing forecast. Improved housing affordability as a result of more modest house price increases, better than expected income gains, or more rapid rebuilding efforts is the primary avenue through which the forecast for residential construction could surprise to the upside.

Downside risks. The distribution of COVID-19 vaccines remains a primary risk. The baseline forecast assumes that herd immunity will be reached this summer. However, there is still the risk that public mistrust of the vaccines could slow their adoption and usefulness, delaying herd immunity and causing economic growth to fall short of expectations. A more devastating risk is the possibility that new variants of the virus are either partially or fully resistant to current vaccines. Under such a scenario, the odds of widespread lockdowns would increase, stressing the global recovery. Under such a scenario, investment spending and the housing market would retreat once again, undermining construction spending and employment.

*Colin Seitz
March 2021*

Real Estate Market Is Surging Again

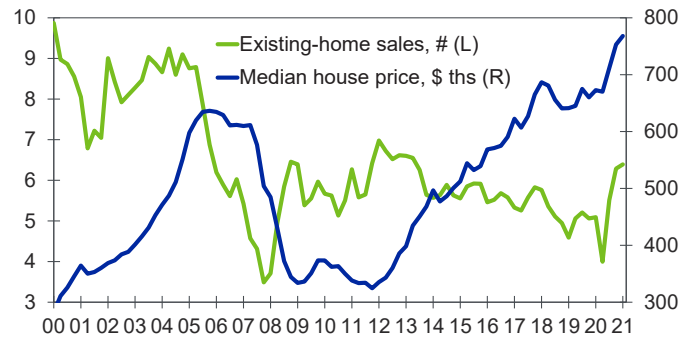
Construction permits, Sonoma County, 3-mo MA



Sources: Census Bureau, CIRB, Moody's Analytics

After a brief lull at the height of the pandemic, residential and nonresidential permitting is roaring back in Sonoma County. The pace of permit issuance is below that seen in 2019 as the rebuilding efforts from the Tubbs fire are largely complete. Yet the trajectory in recent months points to a strong 2021. Robust house price appreciation and a still-low supply of homes will encourage homebuilders to get in on the action.

Prices and Home Sales Recover Swiftly

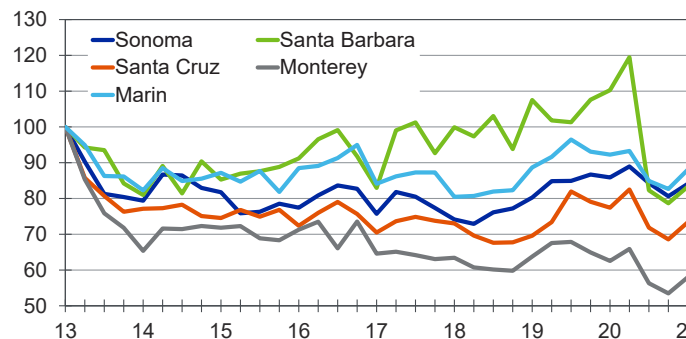


Sources: CoreLogic, California Assn. of Realtors, Moody's Analytics

Stay-at-home orders depressed home sales during the typically busy summer listing months in 2020. Would-be sellers held off on listing, and home sales registered their slowest pace in nearly a decade. However, with contagion fears easing in recent months and the vaccine rollout underway, home sales have come surging back. Meanwhile, house price appreciation has soared as inventories remain low and demand for Sonoma's high quality of life has pushed more residents to snap up available property.

Affordability Declines Begin to Slow

Composite housing affordability, 2013Q1=100

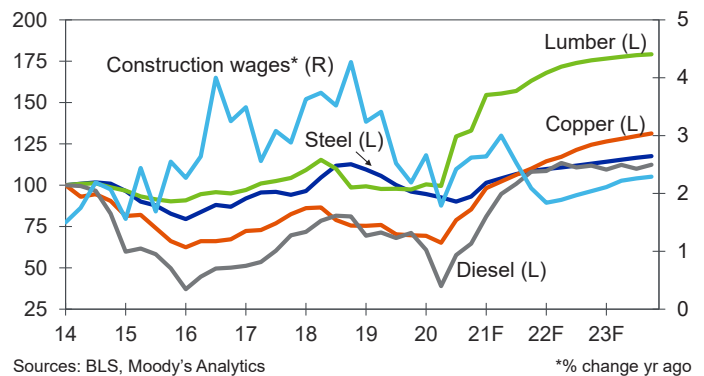


Sources: California Assn. of Realtors, Census Bureau, Moody's Analytics

Housing affordability remains the key challenge facing Sonoma County's residential real estate market. Slowing house price appreciation over the past year has helped ease some of the concern. The county's high quality of life and relatively low business costs make it attractive to potential residents and entrepreneurs. The improvement in housing affordability 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 global economic recovery will increase labor market tightness for construction workers and push up prices for housing materials. Demand for commodities is already showing signs of accelerating as vaccines begin to roll out across the globe, and timber prices in particular are surging.



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