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REAL ESTATE & CONSTRUCTION INDUSTRY

INDUSTRY REPORT

2023

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CONTENTS

4. EXECUTIVE SUMMARY

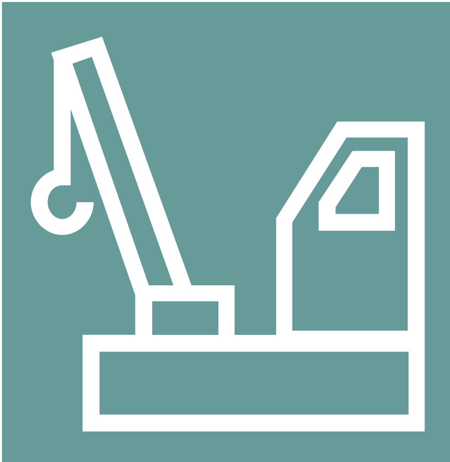
6. REAL ESTATE & CONSTRUCTION: SONOMA COUNTY

EXECUTIVE SUMMARY

August 2023

The Sonoma County Economic Development Board (EDB), in partnership with the Sonoma County Workforce Investment Board (WIB), is pleased to present the 2023 Real Estate & 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



Builders will see relief with softening commodity prices. Lumber producers and other industrial supply chains have improved, reducing costs for builders. Labor expenses are elevated, with a record level of construction industry positions open in Sonoma County. Construction wages gained 10% during the last quarter of 2022, but, in the short-term, this growth may slow with the overall loosening of the labor market. Looking further into the future, the construction industry is predicted to slowly grow and stabilize, although, some of this will be dependent on demographic trends. Food, beverage, consumer goods, and hospitality operators are expanding for developers in the area, which will help the contruction industry grow.

The residential real estate market is struggling, but the worst is in the rearview mirror. Rising mortgage rates combined with the lack of affordable homes has created a hostile environment for residential buyers. This problem is exacerbated by the difference between the effective mortgage rate and the current mortgage rate. Currently, 90% of homeowners have an interest rate below 6%, creating a tight market for buyers and sellers alike, as well as those employed by real estate services. Residential affordability in the long term, however, is projected to get better. There was a high number of single-family and multifamily housing permits issued at the start of the year, which will help increase supply.

Commercial real estate is in decent shape, with the higher vacancy rates explained by an increase in supply. Commercial building permits are being issued at a slow growing rate, following demand for office space with many employers promoting hybrid schedules and remote work rates stabilizing. The office real estate market may be hurt by the short-term reduced demand for workers, however, the long term outlook is good. Retail real estate presents a different set of challenges. Retailers have not recouped their pandemic-induced job losses, and the growth of e-commerce is projected exacerbates this trend. As such, demand for retail spaces is expected to shrink. Overall, commercial real estate market is stabilizing.

Recent Performance. Sonoma County has lost momentum from earlier in the year. Top-line job growth has faltered for the last ew months, falling behind the state and U.S. averages and widening the gap between Sonoma County's recovery and the nation's. Seesawing job gains have left top-line employment mostly flat since January and still shy of pre-pandemic levels, a disappointing esult given that both California and the U.S. achieved full recoveries about a year ago.

The residential real estate market is struggling, but it looks like the worst is in the rearview mirror. The Case-Shiller single-amily house price index had declined on a monthly basis for nine consecutive months through February, but it has improved since early spring. Rising mortgage rates coupled with a lack of affordability sapped demand for Sonoma homes, sending prices tumbling for the better part of a year. Even with the retreat in house prices, the sizable runup during the initial post-pandemic years still has prices up more than 25% from their pre-pandemic levels, and they are inching higher again.

Commercial real estate is in decent shape. Office, industrial and retail vacancy rates were higher in the fourth quarter of 2022 than they were pre-pandemic, though the increase is in part due to increased supply. Nonresidential permit issuance remains slightly higher than it was pre-pandemic but has fallen back to ear-y-2022 levels following a surge last summer.

Macro drivers. The U.S. housing market is defying expectations as a tight supply of homes offsets the weight of higher mortgages rates. However, the market remains overvalued, and with affordability near a three-decade low, the expectation is for the housing market to descend further into cor-ection, albeit at a slower pace than last year.

The strength of the labor market is a determining factor of the housing outlook, and June data showed more signs of cooling. April and May payrolls were revised down by a significant margin, and the June figure came in below consensus expectations. Job gains will weaken well into next year as high interest rates take a toll on confidence and overall economic activity. However, as long as layoffs emain muted, a sharp rise in foreclosures like that of the Great Financial Crisis will be avoided, making a collapse in house prices unlikely.

The Federal Reserve is keeping a close eye on the labor market as its key channel to bring inflation down. Job openings fell in May and June, bringing excess labor demand closer to the Fed's target of 2 million. On the other hand, the quits rate—which is a helpful leading indicator of wage growth—trended lower. We expect the decline to continue in the second half of the year, which would augur favorably for slower wage growth and take the edge off the Fed's hawkish stance.

Insufficient housing supply will remain a thorn in the side of potential buyers. With more than 90% of borrowers carrying an interest rate below 6%, owners who may otherwise have wanted to sell and move are holding back rather than face the shock of new, higher mortgage payments. This is putting downward pressure on already-skinny inventory. The shortage of existing homes for sale is pushing motivated buyers to consider purchasing new homes, but this has not fully compensated.

The shortage of existing homes for sale will be a tailwind for homebuilders. After falling throughout 2022, applications for single-family homebuilding permits rose in the first half of 2023. This was a contributing factor to the National Association of Home Builders' Housing Market Index hitting 55 in June, rising above the 50-point threshold marking positive building conditions for the first time since July 2022. Multifamily permits are off their 2021 peak but remain on par with their 2019 level. Strong underlying demand for apartments from millennials and Gen-Z should keep the pipeline healthy, but near-term weakness is expected given the record number of projects under construction.

House prices have climbed for the third consecutive month, rising 0.6% from May to June, according to the Moody's Analytics House Price Index. June's increase brings house prices back to their July 2022 peak, erasing all declines during the second half of last year. That said, given current levels of overvaluation and the slowing economy, the baseline outlook expects house prices to decline by about 5% over the next two years.

The outlook for the office market is still murky but should begin to improve. Evidence is growing that the share of the labor force working from home has leveled off and may even be declining. Data from Kastle Systems on badge swipes show that the proportion of workers returning to the office nationally has risen significantly over the past year. Further, surveys of major corporate employers suggest that more companies are pulling workers back to the office. If companies insist that the bulk of their workers show up three or more days a week, the ability to reduce the amount of office space needed will be limited, reducing the likelihood of a collapse in office demand.

Industry drivers. Sonoma has now shed residents in six consecutive years, though the pace of departures halved in 2022 and timely Equifax data show less out-migration during the past year. Nonetheless, housing affordability ranks among the worst nationally, which is pricing residents out and pushing some to relocate in lower-cost areas in the state. Cooling house price appreciation will help alleviate some of the affordability concerns, moving the Moody's Analytics affordability index off its bottom from late 2022. Furthermore, while affordability remains a chief concern, the county does rank favorably relative to the state and nearby metro areas, which could help swing migration patterns in its favor.

Looking beyond the recent months' rally, the near year-long decline in prices has helped chip away at affordability concerns, and more buyers are comfortable buying at the current prices. The decline in house prices has put them at a level more consistent with underlying economic fundamentals, including household formation and income growth. In fact, house prices in the county are no longer overvalued, which signals a more balanced housing market. Despite some slowing, the resilience of the labor market will translate into healthy wage growth, keeping a floor under house prices even as mortgage rates remains elevated.

The commercial real estate outlook is a mixed bag. The impacts of the COVID-19 pandemic were pronounced across all property types, and the degree to which they are recovering varies widely. Hotel construction, which was largely put on pause during the pandemic, is set to rev up as builders play catch-up to match demand for new rooms. Hotel space prior to the pandemic was insufficient, and commercial builders are growing more confident that the upward trend in visitor traffic prior to the pandemic will return.

Retailers, on the other hand, were struggling before the pandemic and will see only a modest recovery as foot traffic in the county has normalized following the pandemic. Retailers have still not recouped all their pandemic-induced job losses; payrolls are down 5% compared with early-2020 levels despite making a full recovery nationally. The shift to e-commerce and less foot traffic with a smaller daytime population due to remote-work arrangements have left retailers in a bind, and some are opting to not renew their current leases. Vacancy rates for retailers in the first quarter jumped again to 8.1%, according to Keegan & Coppin, the highest

reading in eight quarters and well above their prerecession level.

The office market will also be hurt by reduced short-term demand for workers as the economy slows. Office vacancy rates have inched lower from their peak in late 2022 but are still higher than they were in the pre-pandemic years. This will likely improve slightly as more companies return to hybrid work environments and planned additions to office space are minimal, which will put some downward pressure on vacancy rates. Importantly, Sonoma's office-using industries are a much smaller share of the economy than in other metro areas, so the hit from remote work has had a markedly smaller impact.

Other property types are a bit more mixed. The industrial market should hold steady as e-commerce demand slowly backtracks with more spending geared toward services. The industrial market was among the biggest winners during the pandemic as durable goods orders surged. However, while industrial vacancy rates are below their pre-pandemic level, further declines are unlikely in the near term given a pullback in goods spending and slower economic growth through the rest of the year.

Short-term pricing. While affordability issues will crimp demand, mortgage rate lock-in effects will keep supply limited and put a floor under house prices. Key to the recent increase in prices has been the limited supply of homes for sale. There are just over three months' supply of existing single-family homes for sale on the market. Although this is up from the record low of less than two months in early 2022, it remains well below its pre-pandemic level and the four to six months of inventory that represents a balanced housing market. The biggest hurdle to greater supply is the spread between the effective mortgage rate and the current mortgage rate. Homeowners locked into ultra-low interest rates over the past three years, which is providing a strong incentive to stay in their homes. The effective mortgage rate, which is the average rate on all outstanding mortgages, is 200 basis points below the current mortgage rate.

Persistent weakness in existing-home sales will be a tailwind to homebuilders. After falling throughout 2022, applications for single-family homebuilding permits rose in the first half of 2023 as homebuyers returned to builders' developments.

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 poised to continue its growth this year and into 2024, vacancy rates across most property types will decline and prices will rise. Retail is a key exception: Both vacancy rates and prices will be the slowest to recover. Vacancies were already rising prior to the pandemic, and retailers will continue to be pressed by the advance of e-commerce.

Operating expenses. Commercial and residential builders will see relief with softening commodity prices. Falling prices for lumber and other building materials as supply chains have improved have given builders some margin to work with to make concessions while still turning a profit. On the other hand, labor expenses are still elevated. There is a record level of open positions in the construction industry, and even with the national economy slowing, there is still robust demand for construction projects given the massive pipeline of units under construction. Construction wages in Sonoma County were up 10% through the fourth quarter of 2022, but this should subside as the economy slows and the labor market loosens.

Oil prices have come in significantly over the past year but will inch higher through the remainder of this year. Higher oil prices feed into the cost of transporting large construction materials and raise the cost of powering machinery.

Returns. Persistent weakness in existing-home sales will be a tailwind to homebuilders. After falling throughout 2022, applications for single-family permits rose in the first half of 2023 as homebuyers returned to builders' developments. Faced with the prospect of rising inventories, homebuilders have been more willing to negotiate with buyers. Falling prices for lumber and other building materials as supply chains have improved have given builders some margin to work with to make concessions while still turning a profit.

Still, with mortgage rates elevated and the prospect of further rate hikes still on the table, house prices will inch down in the near term, which will pressure margins lower. Returns in the commercial real estate market will be mixed. Vacancy rates across retail and office markets are each nearly a full percentage point above their levels from last year, limiting the need for new commercial development, and will keep rent growth muted.

Long-term outlook. The long-run outlook for Sonoma's residential market is upbeat, with years of underbuilding ensuring that the county will still need to play catch-up to bal ance the housing market. Still, demographic trends will play a far more important role in the long term, and while there has been a slight improvement over the past year, consistent out-migration will curb housing demand unless demographic trends improve.

The changing of the demographic guard is at hand, and millennials are diving into homeownership as they start families. Better income gains and improved job prospects once the economy revs up again in late 202 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 hospital ity operators will create fertile ground for com mercial developers. However, the construction of new office buildings will proceed at a mor modest pace as office-using industries expand into existing space and the acceptance of remote work chips away at some demand for office space. The outlook for retail is mor challenging. 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 opportu nities, proximity to the Bay Area, and relativel 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 con struction could surprise to the upside.

Downside risks. The financial system is stabilizing, but the Fed's tightening could expose vulnerable financial institutions to insurmountable stress, worsen lending conditions, and create a credit crunch. Lenders have self-tightened since the spring banking crisis, though not much more than expected. If banks continue to tighten, business investment and consumer spending will turn sharpl downward, weighing heavily on the U.S. economy.

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