



Industry Sector Report

Construction Industry Insider

2011
SONOMA COUNTY

EDB
SONOMA COUNTY
ECONOMIC DEVELOPMENT BOARD

SONOMA COUNTY
WORKFORCE INVESTMENT BOARD

April 2011

The Sonoma County Economic Development Board (EDB), in partnership with the Sonoma County Workforce Investment Board, is pleased to present the *2011 Construction Industry Insider* for Sonoma County. Our research partner, Moody's Analytics, provided the research for this report.

Highlights of the *2011 Construction Industry Insider* include:

- After being hit hard by the recession, the construction industry in Sonoma County is beginning to show some indicators of recovery, including increasing employment.

- Improving demographic trends will bode well for housing demand. The population has been increasing and is expected to continue to increase. The population of those aged 25 to 39, the prime home buying years, is stable for the first time in decades.

- Sonoma County still has a large share of homes in the foreclosure processes, and distress sales and bank auctions are expected to drive a 7% decline in existing prices from their current level. However, existing-home prices are expected to begin rising in 2012 and at a faster pace than that of the nation.

- Construction will contribute a smaller share of economic growth in Sonoma County in the future than before the recession. The long-run pace of homebuilding will be slower, keeping housing inventory in check.

Thank you for your interest in the Economic Development Board's research. For additional information, questions, comments, or suggestions please contact us at (707) 565-7170 or visit www.sonomaedb.org.

Sincerely,

Ben Stone

Ben Stone
Executive Director

MOODY'S ANALYTICS

SONOMA COUNTY WORKFORCE INVESTMENT BOARD

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Recent Performance

Construction is showing some signs of life in Sonoma County. Construction employment has gradually increased over the past year, gaining more momentum in recent months. Residential building permits are showing signs of upward movement but remain close to historic low levels. The inventory of unsold houses is still very high as a result of the slow sales pace. House prices are inching lower again after a modest increase in late 2009. The Case-Shiller House Price Index remains 43% below its early 2006 peak.

Nonresidential construction is gradually increasing, but additions and alterations to existing buildings have accounted for nearly three-quarters of recent construction. Construction of office, industrial and retail space remains virtually nonexistent.

Macro Drivers

The U.S. recovery is gaining momentum, although downside risks are also increasing. GDP grew 3.1% in the fourth quarter of 2010 and 2.9% for the entire year, following a contraction of 2.6%in 2009.

The pace of improvements in the labor market will be slower. After approaching 10%, the unemployment rate has recently fallen largely because of the still-contracting labor force. The jobless rate will tick upward briefly as formerly discouraged workers re-enter the workforce, partly masking the improved pace of job creation before falling below 9% by the end of the year. Private sector payrolls will grow by 1.7 million new jobs after shedding close to a million jobs in 2010.

The housing market will begin to stabilize this year as job growth accelerates. With faster job growth and high housing affordability, new- and existing-home sales will pick up, averaging around 5.4 million units in the U.S. in 2011. Constraints on financing, weak residential construction, and a large inventory of existing homes will partly offset stronger demand, but the pace of homebuilding will rise to about 900,000 units by the end of the year.

Prices will be the one of the last measures of the housing market to turn the corner. Although the rate of foreclosures started has fallen sharply in the U.S. in recent months, there is still a large backlog of houses in the foreclosure process, which will put downward pressure on home prices. According to RealtyTrac, REO sales alone accounted for 17% of sales in the fourth quarter. The Case-Shiller House Price Index is expected to decline by about 5% from its current level, reaching its final trough in the third quarter.

Household credit conditions will continue to improve, setting the environment for increasing loan demand and extension of mortgage credit. According to the Federal Reserve, most banks have yet to begin relaxing lending standards, even for prime mortgages. A strengthening recovery and improved bank asset sheets will allow the process to begin.

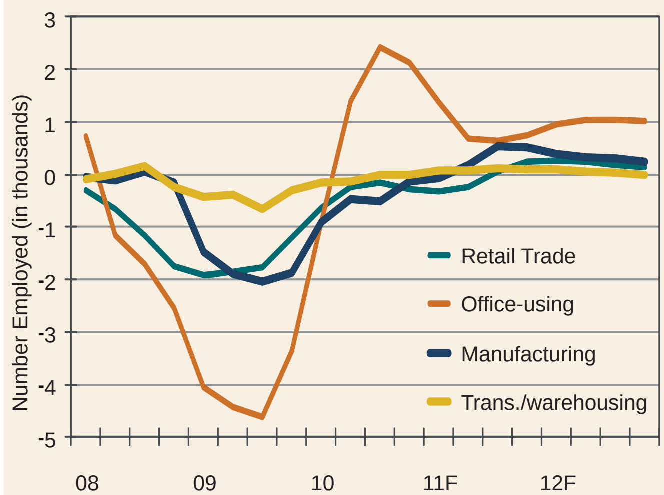
Increasing mortgage rates mark the beginning of a rise in housing borrowing costs. The 30-year conventional mortgage rate has increased from its low of 4.2% in October 2010 to 5% as of February. Mortgage rates will rise over the next several quarters as the government's intervention in the mortgage market ends. The 30-year conventional rate is expected to reach 6% by the end of 2011.

The slow recovery of commercial real estate prices will accelerate in 2011. Commercial property prices are now beginning to rise, according to Moody's Investors Service, with multifamily residential property prices rising the most on a year-ago basis and other commercial property types lagging.

Limited access to credit remains a stumbling block for nonresidential construction. According to the Federal Reserve, banks are reporting stronger demand for commercial real estate loans, but they have only recently stopped tightening lending standards.

Slow Growth for Users of Commercial Space

Sonoma County employment, change yr ago, thousands



Sources: BLS, Moody's Analytics

Sonoma County's job growth is leading the national average for now, but it will not accelerate as substantially in 2012. Furthermore, growth will remain tepid among many of the key industries that demand commercial real estate, including manufacturing, transportation and retail trade. As a result, construction of new commercial space will focus on replacing outdated space. Office-using industries will lead the county's job growth over the next several quarters and will be the first to recover all of the jobs lost during the recession.

Industry Drivers

Residential construction is beginning to regroup in Sonoma County, but the recovery will not hit full stride until later in the year. A sizeable backlog of unsold houses—*8 months according to the California Association of Realtors*— will prevent homebuilding from ramping up as fast as the U.S. pace. Nevertheless, homebuilding has been weak for so long that this inventory should dry up quickly as demand recovers. Demand will strengthen even more once prices settle at their trough in the third quarter of 2011.

Improving demographic trends also bode well for housing demand. Population growth has been accelerating since 2007, and it is expected to remain strong for years to come. Greater housing affordability is helping attract more young families and first time homebuyers. Indeed, the share of the county's population in the prime home buying ages of 25 to 39 is now stable following decades of decline.

Construction of office space will be slow to recover. According to Keegan & Coppin Co., the office vacancy rate has steadily declined over the past four quarters, although at 22.3% as of the fourth quarter, it is still nearly 4 percentage points above its prerecession level. Employment in office-using industries was especially hard hit in the recession and these industries will take years to fully recover. Construction of new office space remains minimal and no new projects were started over the past year. Thus, new buildings will not aggravate the oversupply problem, although State Farm's move out of Rohnert Park in mid-2011 will add up to 2 percentage points to the county's vacancy rate.

Demand for new industrial space will ramp up more quickly than for office space in the near term. The vacancy rate is substantially lower in the industrial market than in the office market; the industrial vacancy rate fell to 13.9% in the fourth quarter from 15.5% at the end of 2009. Manufacturing payrolls have steadily increased since the fall. Growth is expected to continue in the near term, albeit more slowly than when manufacturers boosted output to meet pent-up demand— especially for IT equipment—in the first part of the recovery. Medtronic's Sonoma County unit has approval to begin producing two new medical devices and additional devices are still awaiting approval. Recent improvements in pricing and demand for the county's high-priced wines will translate into higher usage of bottling and distribution facilities.

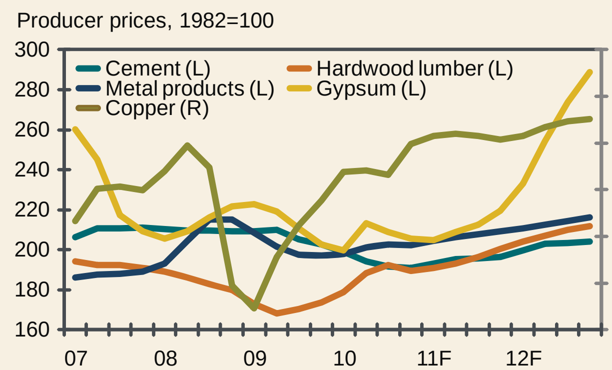
Finally, demand for retail space will slowly improve over the near term. At 8.5%, the vacancy rate for retail space remains far lower than the rate for the other commercial markets, but it remains more than twice as high as its prerecession average and it has not declined significantly over the past year. Consumer spending growth will gain momentum in 2011 amid steady job growth and a moderating unemployment rate. Notwithstanding Sonoma County's high foreclosure rate, credit conditions for other types of consumer debt are lower than the California averages and generally on par with the national averages. On the downside, the county's households still have a high debt service burden, and the substantial loss of wealth since the beginning of the housing correction will weigh on consumers propensity to spend.

Pricing

Pricing power will remain soft for homebuilders in 2011. New-home prices are expected to begin increasing soon, but Sonoma County still has a relatively large share of homes in the foreclosure process. Thus distress sales and bank auctions are expected to drive a 7% decline in existing prices from their current level. By 2012, existing house prices are expected to begin rising at a faster pace than those for the nation, with year-to-year appreciation of about 5%. The county's housing affordability will still be near its highest point in decades, attracting many first-time buyers.

Prices for nonresidential buildings are beginning to firm and will continue to improve. Although the office vacancy rate remains high, its steady decline over the past year has helped rents inch higher. However, the price spread between Class A and Class B space has narrowed in recent years and rents for Class B space are expected to decline. Rental rates for industrial space were relatively sturdy during the recession and they have not yet begun to increase. These rents are expected to pick up gradually over the year ahead as the recovery boosts warehousing and manufacturing. Finally, rental rates for retail space are improving and will continue to rise. Consumer spending has been one of the first national measures to surpass its prerecession level. County households will be in better shape over the year ahead as job growth accelerates and the unemployment rate gap with the U.S. narrows.

Prices Will Remain Tame for Most Inputs



Sources: BLS, Moody's Analytics

Prices for most building materials will rise slowly because of the recovery's slow pace. In particular, nonresidential builders will benefit from the low price of cement, which is expected to remain below its prerecession average for several quarters to come. Most other building material prices have recovered from the recession, but they are increasing more slowly than prices of intermediate goods as a whole. However, copper prices have surged by 25% over the past year and are already slightly above their mid-2008 peak. The price of gypsum is expected to begin rising by the end of 2011.

Operating Expenses

Builders are still enjoying relatively low input costs, but this will begin to fade as construction ramps up during the recovery. Input costs for homebuilders have eased in recent months as prices for lumber and nonmetallic minerals such as cement and gypsum have slipped. However, the price of lumber is expected to increase rapidly over the next several quarters as homebuilding increases throughout the U.S.

Nonresidential construction will increase more gradually than homebuilding over the year ahead. As a result, prices for commercial inputs will rise more slowly. Prices for steel and other structural metal products are expected to increase at about the same pace as other intermediate goods.

Some rising commodity prices will squeeze both residential and nonresidential builders. Copper prices have reached a new high and are still increasing because of declining inventories and increasing optimism about the health of the global economy. Meanwhile, higher energy costs are adding to the cost of transporting materials and operating heavy machinery. The price of crude oil recently surpassed $100 per barrel for the first time since 2008. Unrest in the Middle East has attached a risk premium to the price of oil, although it has not significantly disrupted the supply. Risks for energy prices are weighted to the downside.

Construction labor costs will remain contained. Payrolls are expected to begin rebounding gradually, but construction lost a far greater share of jobs during the recession than any other industry. As a result, slack in the industry's labor pool will keep a relatively tight lid on wage growth.

Profitability

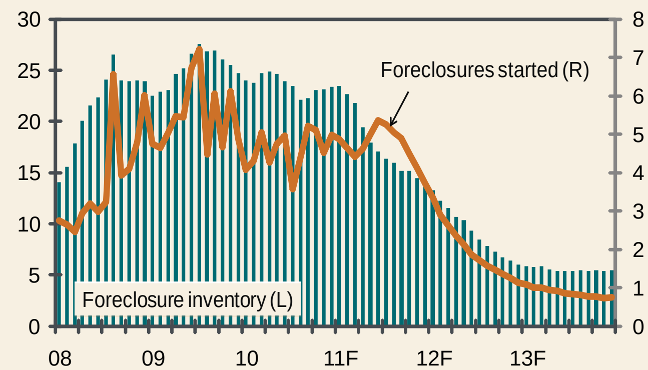
Homebuilders will eke out relatively modest profits in 2011. New-home prices will begin to increase, but gains will be limited by ongoing declines in existing-home prices. Input costs remain low despite increasing for some key goods.

Profitability will be slightly better for nonresidential construction. Prices will increase across the different types of commercial properties, while the costs of building materials will increase at a more gradual pace. Builders of larger properties will fare better, while some distressed sales will still weigh on the market for smaller properties.

The National Council of Real Estate Investment Fiduciaries property index, which measures the rate of return on investments in real estate, was positive in the U.S. throughout 2010. At 4.6% in the fourth quarter, the index is slightly above its prerecession average and well above its year-ago level of -2.1%. The return on investment is currently positive for all major property types, but it is the highest for apartments and lowest for hotels and industrial buildings.

Declining Foreclosures Will Spur Building…

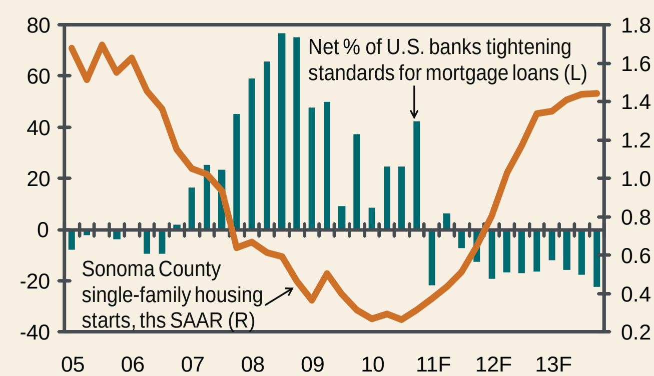
Sonoma County, # per ths households



Sources: Fiserv, Moody's Analytics

Clearing out foreclosed properties will be essential to stabilizing prices and spurring demand for new houses. Sonoma County still has a sizeable inventory of houses in the foreclosure process and the rate of foreclosures started remains steady, even as it has declined in the U.S. for several months. The county's rate of new foreclosures is expected to increase briefly in mid-2011 as moratoriums are lifted; however, it will then subside thanks to the improving labor market and stricter lending standards. The backlog of foreclosed houses will return to normal by 2013.

…As Will Gradually Loosening Credit



Sources: Federal Reserve Senior Loan Officer Survey, Census, Moody's Analytics

Banks are set to begin the gradual process of relaxing mortgage lending standards. This transition is essential to the recovery of housing demand and starts, which are expected to improve steadily. However, Sonoma County's small and midsize banks still have a large concentration of bad loans on their books. Of the county's three TARP recipients, one was closed by the FDIC in 2010 and the other two have yet to repay their outstanding capital injections. This will limit their ability to expand lending to local businesses until the quality of their loan portfolios improves.

Long-Term Outlook

Construction will contribute a smaller share of economic growth in Sonoma County in the future than before the recession. The long-run pace of homebuilding will also be slower, keeping the inventory of homes in check. House price appreciation is also expected to be more moderate. Although Sonoma County's housing affordability has improved during the correction, it is still well below the national average and is even lower than the California rate.

Retail space is expected to lead commercial construction in the county. The retail market consistently has the lowest vacancy rate, while strong income trends and improving population growth bode well for spending.

Office-using industries are expected to lead job growth in the county over the long run. Sonoma County is poised to attract some financial and professional services from other parts of the San Francisco Bay Area. However, the county's glut of vacant space and shortage of undeveloped land will limit the construction of new office space.

Finally, construction of industrial space will be very limited over the long run. High tech industries have traditionally been a major source of demand, but these industries will increasingly focus on research and development, while more low-value production will be outsourced. This trend will limit the demand for new or expanded assembly sites.

Upside Risks

Sonoma County's housing affordability remains below the national average, but it is at its highest level in 10 years, and further near-term price declines are expected to push affordability even higher. This could unleash even more pent-up demand than forecast, as more first-time homebuyers re-enter the market and new residents are drawn to the area for its high quality of life.

The recovery and structural change of the county's high-value and high-profile wine industry is an upside risk for industrial real estate and tech companies catering to internet- based retail. As more states remove their remaining restrictions on the interstate wine shipments, profit opportunities will increase for firms that create and manage web-based wine retail and shipping operations.

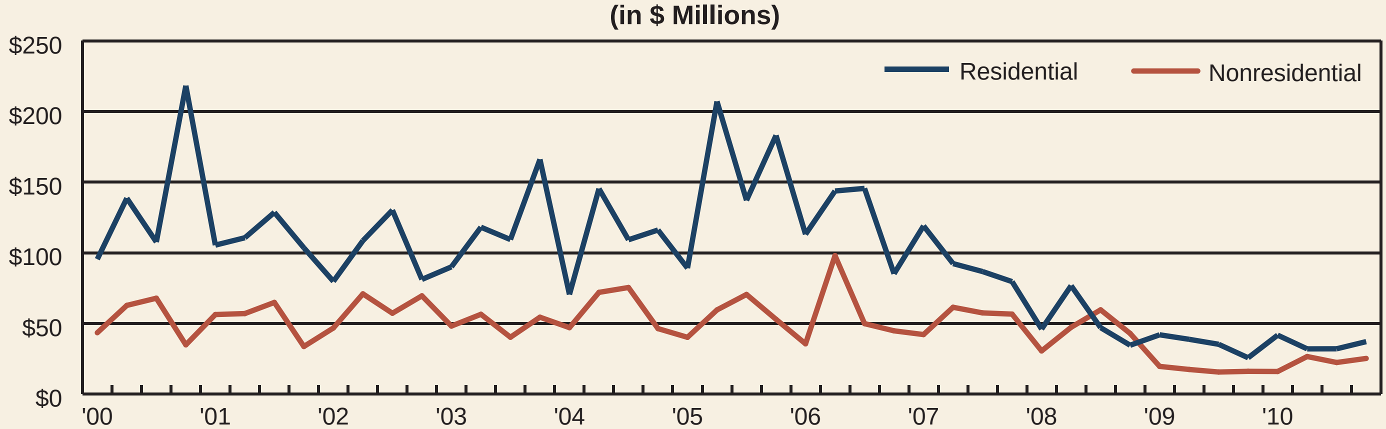
Downside Risks

The potential for an oil price shock is the main downside risk for the recovery and also a significant threat for construction in the county. Oil price spikes would extend to other commodities, putting further upward pressure on construction costs. Furthermore, higher oil prices would undermine consumer confidence and could derail the recovery of home sales.

A slower decline in foreclosures could prolong the house price correction. The moderate drop in prices in the first half of this year could give way to extended declines in the second half of 2011 if foreclosures persist.

The county's industrial real estate market faces some downside risk from the potential for even more outsourcing of tech production. The global recession has reduced manufacturing costs and wages for skilled workers in Europe and Asia. Firms in the life sciences and other high-value industries are likely to capitalize on lower overseas costs for skilled labor. Illustrating this threat, JDS Uniphase recently opened a $20 million plant in China.

Value of Residential & Nonresidential Building Permits Issued (in $ Millions)



Source: Construction Industry Research Board

EDB
Sonoma County
Economic Development Board

With Acknowledgment and Appreciation to Local Key Businesses Supporting Sonoma County Economic Development:

Director

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