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Construction Insider 2010

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Construction Insider 2010

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The Sonoma County Economic Development Board (EDB), in partnership with the Sonoma County Workforce Investment Board (WIB), is pleased to bring you the 2010 Construction Report. Our research partner, Moody's Economy.com, produced this report for the EDB. Highlights include:

- The worst may be over for construction in Sonoma County, but the industry has yet to begin rebounding from its deep recession. Construction employment is still declining much faster than most of Sonoma County's other industries, and building has not begun to pick up yet.

- The still-large backlog of unsold houses in Sonoma County will limit the demand for new residential structures in the short-run. According to the California Association of Realtors, the area's five-month backlog of unsold houses is still well above its pre-housing boom level, and it has not fallen substantially over the past year.

- Nonresidential construction is expected to remain flat over the months ahead. Limited access to credit will be a key stumbling block for many commercial builders. Lenders remain on edge as commercial real estate prices are falling and mortgage delinquency rates are rising.

- Pricing power will remain limited for homebuilders. House prices in Sonoma County rebounded modestly in 2009, but this trend is not expected to last. The number of distressed home sales eased recently as the foreclosure rate leveled off, but the foreclosure pipeline is still filling quickly. As a result, the Case-Shiller Home Price Index is expected to fall by an additional 9% before the county's house prices bottom in the third quarter of 2010. Price growth will then gradually accelerate through 2012, when it is expected to reach a year-to-year pace of about 7%.

Sincerely,

Ben Stone

Executive Director

Recent Trends. The worst is over for construction in Sonoma County, but the industry has yet to begin rebounding from its deep recession. Construction employment is still declining much faster than most of Sonoma County's other industries. Residential building has not begun to pick up yet. The inventory of unsold houses has not fallen substantially over the past year, although it is below its mid-2008 peak. House prices have been steady over the past several months after increasing during most of 2009, but the Case-Shiller House Price Index is still 43% below its early-2006 peak. Single-family housing starts are still inching lower. Multifamily housing starts, on the other hand, have increased with the recent groundbreaking of three new low-income apartment buildings.

Nonresidential construction has fallen sharply over the past year, and it has been flat in recent months. Rising vacancy rates, particularly for office space, are keeping new construction in check. Demand for existing space is weak, as most industries are still downsizing in Sonoma County. Throughout the U.S., business investment in structures is still weighing heavily on GDP growth.

Macro Drivers. The U.S. is beginning to recover from the recession, led by increasing consumer spending and industrial production. Growth in business inventories was much stronger in the fourth quarter, contributing to strong GDP growth. However, the pace of the recovery still hinges on a rebound in the labor market, which has yet to materialize. Job losses have eased, but new hiring is almost nonexistent.

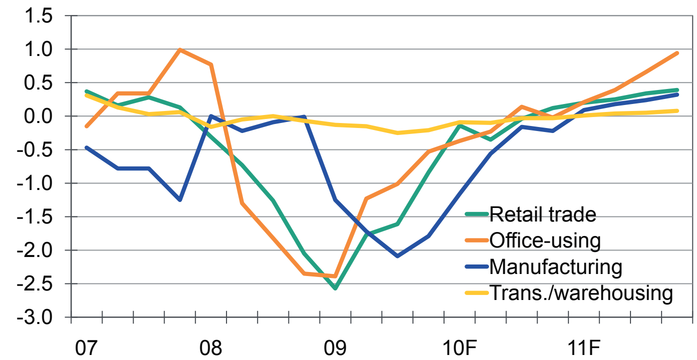
The housing market is also still on shaky ground. Home sales surged in the nation in late 2009 as homebuyers rushed to take advantage of the first-time buyer tax credit. The run-up in sales also helped prices stabilize. However, even though the tax credit was extended through June 30, sales have dropped off sharply in recent months. New-home sales have been particularly weak and homebuilding has fallen flat.

The high mortgage foreclosure rate is the primary obstacle to the housing market's turnaround. The foreclosure pipeline is still full, with many households throughout the nation in late stages of delinquency. Meanwhile, the federal Home Affordable Modification Plan has helped too few homeowners to put a dent in foreclosures. Homes sold in foreclosure auctions will put downward pressure on prices and add to the supply of homes on the market until the second half of 2010.

Low mortgage rates will continue to prop up sales, but rates will not stay at current levels indefinitely. The 30-year conventional mortgage rate has been hovering near its all-time low but has begun inching upward to 5%

Limited Job Growth Will Contain Construction

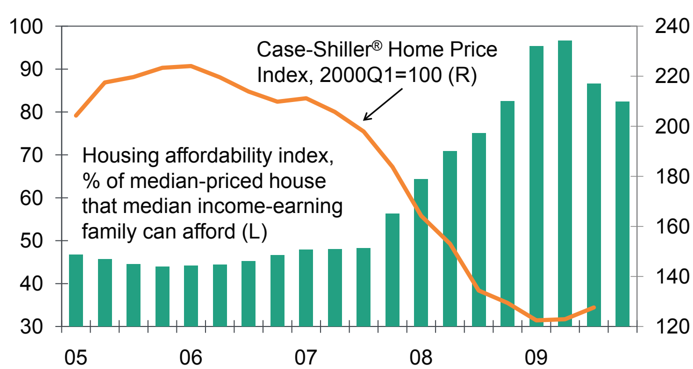
Employment, change year over, thousands



Sources: BLS, Moody's Economy.com

Sonoma County's job growth will lag the national average over the next several quarters. In particular, the key demand drivers for nonresidential real estate will be flat in 2010. Manufacturing and transportation will be the slowest to turn around, although industrial production is increasing. Retail trade will also be relatively slow to rebound, as consumer conditions remain fragile. Finally, office-using industries, including professional, financial and information services, will not recover quickly, but they will become a leading source of growth as the recovery gains steam.

Some Recent Affordability Gains Will Be Lost



Sources: Fiserv, Moody's Economy.com

Although Sonoma County's house prices have been steady recently, they are expected to fall further. Foreclosures will weigh heavily on prices, but low affordability will remain a drag. Affordability has improved throughout the correction, but the median-house price is still slightly too high for a median income-earning family. Furthermore, affordability will decline over the quarters ahead as mortgage rates gradually rebound from their record-low level. Expensive single-family housing will fuel demand for more reasonably priced multifamily buildings.

recently. Mortgage rates will rise gradually, as the Fed is about to end its effort of keeping rates low through the purchase of mortgage-backed securities.

The limited availability of credit will also weigh on the housing market's recovery, but it is expected to improve over the year ahead. Most financial institutions are no longer tightening lending standards, and their willingness to lend will increase once credit conditions turn the corner. Furthermore, the Treasury Department's pledge to give Fannie Mae and Freddie Mac unlimited assistance for the next three years will boost the availability of mortgage credit.

The nonresidential property market faces many of the same challenges. The availability of credit is even more of an obstacle for expensive nonresidential projects. Falling prices and high delinquency rates are also drags.

Industry Drivers. The still-large backlog of unsold houses in Sonoma County will limit the demand for new residential structures. According to the California Association of Realtors, the area's five-month backlog of unsold houses is still well above its pre-housing boom level, and it has not fallen substantially over the past year. Meanwhile, the county's high rate of mortgage foreclosures and late-stage delinquencies will result in a steady stream of foreclosure auctions over the months ahead.

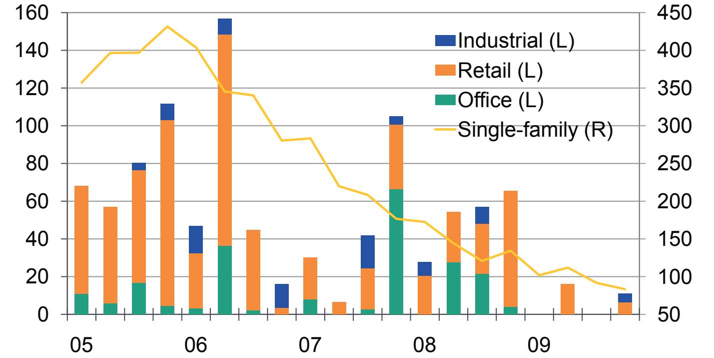
Improving demographic trends will support future housing demand. Population growth has been accelerating since 2007, and it is expected to remain strong for years to come. Greater housing affordability is helping attract more young families and first-time homebuyers. Indeed, the share of the county's population in the prime home-buying ages of 25 to 39 is increasing again for the first time in decades.

Nonresidential construction is expected to remain flat over the months ahead. Limited access to credit will be a key stumbling block for many commercial builders. Lenders remain on edge as commercial real estate prices are falling and mortgage delinquency rates are rising.

Construction of new office space will be particularly weak. According to Keegan & Coppin Co., the office vacancy rate is steadily increasing, reaching 24.8% in the fourth quarter, versus 23% in the previous quarter and 20.5% a year earlier. Employment in office-using industries has been declining at a somewhat slower pace recently. New construction is not adding to the oversupply problem, as the Construction Industry Research Board indicates that no permits for office buildings have been issued since a surge in construction in 2008. Nevertheless, vacancy rates are not expected to begin decreasing until late 2010, when office-using industries start expanding payrolls again. Construction of new office buildings will gain steam after vacancy rates have moderated.

Builders Have Nowhere to Turn for Demand

Building permits, $ mil, SAAR

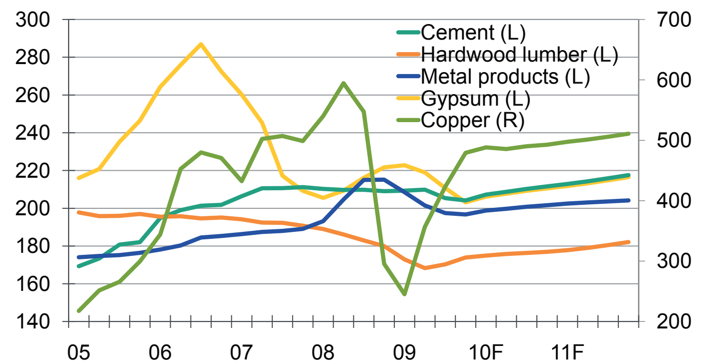


Sources: Census, Construction Industry Research Board, Moody's Economy.com

Building permits remain very weak for both residential and nonresidential projects. A surge in commercial construction helped to offset the decline in homebuilding in 2008, but both have been flat over the past year. The dearth of planned projects will keep pricing power low for builders. Furthermore, vacancy rates are high for all types of properties, particularly office space. As a result, building permits are expected to remain flat over the months ahead and will not begin to rebound substantially until 2011.

Input Prices Will Rise During the Recovery

Producer price indices, 1982=100



Sources: BLS, Moody's Economy.com

The prices of most building materials remain relatively low, but they will increase as the recovery gains traction. Lumber prices are expected to rise at the fastest rate over the near term, as housing starts will begin to rebound soon. However, homebuilders will benefit from the low price of gypsum, which is expected to rebound more slowly. Prices for key nonresidential materials, including cement and steel, will increase at a moderate rate. Finally, copper is one exception, as the price already more than doubled over the past year and is expected to hold steady over the months ahead.

Demand for industrial space is beginning to steady. The industrial vacancy rate inched upward to 15.5% in the fourth quarter of 2009, compared with 15.3% in the previous quarter and 12.8% a year earlier. Manufacturing payrolls, which have been steadily declining since 2001, have been more stable in recent months. Industrial production of medical and other high-tech equipment is rebounding strongly. This trend will support the construction of new warehouses and distribution facilities. However, manufacturers are not expected to increase payrolls substantially in 2010 but rather to exploit recent productivity gains. As a result, demand for new factory space will be limited in the near term.

Finally, construction of new retail space has slowed substantially over the past year, but it is one of the leading sources of nonresidential projects. The vacancy rate for retail space held steady at 9.2% in the fourth quarter but is up from 6.5% a year earlier. Retail is expected to lead nonresidential construction, although it will be slow to fully recover from the recession as consumer conditions are still fragile. Sonoma County's unemployment rate is higher than the national average, and the labor force is contracting at a faster rate. Consumers are saddled with a high debt service burden and the dramatic loss of home equity is imposing a substantial negative wealth effect. On the upside, the county's delinquency rates are below the national average for both credit cards and auto loans.

Pricing. Pricing power will remain limited for homebuilders. House prices in Sonoma County rebounded modestly in 2009, but this trend is not expected to last. The number of distressed home sales eased recently as the foreclosure rate leveled off, but the foreclosure pipeline is still filling quickly. As a result, the Case-Shiller Home Price Index is expected to fall by an additional 9% before the county's house prices bottom in the third quarter of 2010. Price growth will then gradually accelerate through 2012, when it is expected to reach a year-to-year pace of about 7%.

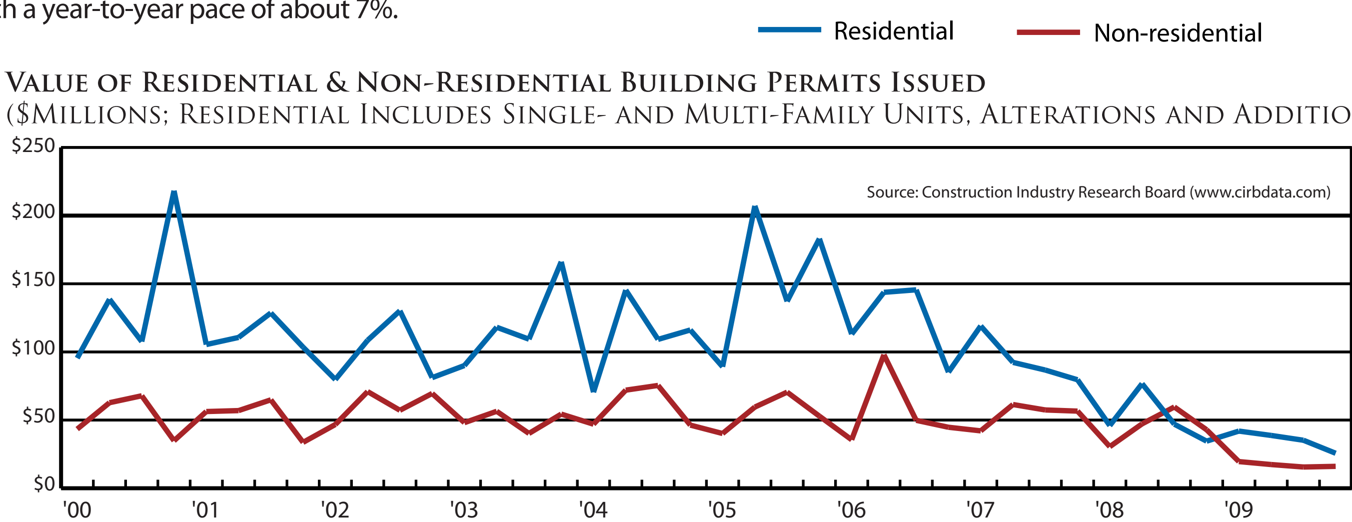
Pricing power is also weak for nonresidential buildings. In particular, the extremely high office vacancy rate is weighing on rents. Meanwhile, the bargain-basement sale of Cisco Systems' former campus could further depress property values and rents in the county. Although demand remains soft, there are signs that pricing is beginning to stabilize. After slashing rents over the past two years, many landlords cannot afford to lower rents any further in order to attract tenants.

Employment is expected to remain flat through 2010, which will limit the need for renters to change spaces to accommodate immediate expansion. However, as businesses regain confidence during the recovery, some will look for new space in anticipation of future growth. This will support the gradual rebound in rents and purchase prices.

Operating Expenses. Low input costs are still helping to offset the weak pricing power in construction, although this source of support is fading as the recovery sets in. The price of hardwood lumber is steadily increasing, but it is roughly on par with its year-ago level. By contrast, the prices of nonmetallic minerals such as cement and gypsum are still inching lower. The prices for steel and other structural metal products have been steady in recent months, and they are roughly in between their prerecession levels and their mid-2008 peak. Meanwhile, prices for other important metals such as copper and aluminum have surged by 70% or more over the past year, and they are only slightly below their prerecession levels.

The prices of crude oil, gasoline and diesel fuel remain well below their mid- 2008 peak, but they have steadily increased over the past year. This will add to the cost of transporting materials or operating heavy machinery.

Value of Residential & Non-Residential Building Permits Issued
($Millions; Residential Includes Single- and Multi-Family Units, Alterations and Additions)



As construction rebounds, the cost of raw materials will rise further. Housing starts will increase gradually throughout the U.S. over the year ahead, before they accelerate more rapidly in 2011. Nonresidential construction is also expected to begin rebounding by mid-2010. However, labor costs will stay contained. Construction employment is expected to remain flat in Sonoma County until 2011, while the county's high unemployment rate will restrain wage growth.

Profitability. Losses are narrowing for construction, but it will still struggle to return to profitability over the quarters ahead. Building costs remain low, but they are beginning to rise as the recovery sets in. Meanwhile, prices for existing homes will fall further, limiting both prices and sales of new homes. Profitability has improved for commercial builders, but rising delinquencies, falling prices, and growing vacancy rates will remain serious drags. The National Council of Real Estate Investment Fiduciaries property index, which measures the rate of return on investments in nonresidential real estate, has rebounded substantially over the past year, but it remains low. The index, which averaged about 3% over the 10-year period before the recession, plunged to -8% in late 2008 and rebounded to -2% by the fourth quarter of 2009. The return on investment is the lowest for hotels, while retail stores have held up the best.

Long-Term Outlook. Construction will contribute a smaller share of economic growth in Sonoma County in the future than in the period before the recent recession. Excessive homebuilding led to a dramatic increase in the supply of houses in the early 2000s. The long-run pace of homebuilding will be slower than it was in the years before the recession, 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 average.

The outlook for nonresidential construction is a bit stronger, but high vacancy rates will be a continuing drag. Construction of industrial buildings is expected to accelerate the most over the years ahead, driven by the county's key wine industry, once demand for high-priced wines recovers. Increasingly large grape crushes will require the addition of space for processing and storage. High-tech industries create another source of demand for industrial space. However, the focus of high-tech companies will increasingly be on research and development activities instead of manufacturing, limiting demand for assembly sites.

Office-using industries are expected to lead the county's long-term job growth. Sonoma County is poised to attract some financial and professional services from the much more expensive Bay Area. However, the county's glut of vacant space will limit the construction of new space. Finally, Sonoma County's strong income trends and improving population growth will fuel construction of retail space.

Upside Risks. Upside risks for construction are relatively limited, particularly in the near term. Although housing affordability is still low, it stands at its highest level in 10 years, and further near-term price declines could push affordability even higher. This will unleash additional pent-up demand as first-time homebuyers enter the market and new residents are drawn to the area for its high quality of life.

Plans for redevelopment of downtown Santa Rosa generate further long-term potential for construction. New commercial and high-density housing could reshape the face of the downtown area. Additionally, the possibility of expanded service from the airport could generate further economic activity.

Downside Risks. Risks for construction are weighted to the downside. The main downside risk is that foreclosures could still increase over the months ahead, driving prices lower. Late-stage delinquency rates remain high, and employment is still declining.

Previously frozen credit markets have begun to thaw, but accessing credit remains difficult for businesses and consumers. If the availability of credit does not improve more significantly over the months ahead, it will severely hamper the recovery of both residential and nonresidential construction.

Nonresidential markets also face the risk that high vacancy rates will remain a drag even after the recovery begins. Manufacturing, transportation/warehousing and retail trade are not expected to regain all of the jobs lost during the recession. Office-using industries are expected to rebound more strongly, but Sonoma County has an enormous glut of vacant office space.

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

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Circle Bank — Your life. Your business. Your bank.

Exchange Bank

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NorBAR — North Bay Association of Realtors

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