



Industry Report Series

2006
Construction Report



Presented by the Sonoma County Economic Development Board, in partnership with the Sonoma County Workforce Investment Board



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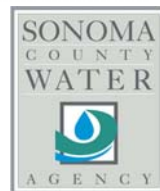
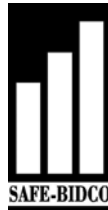


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2006 Construction Report

March 2006

The Sonoma County Economic Development Board (EDB), in partnership with the Sonoma County Workforce Investment Board (WIB), is pleased to bring you the 2006 Construction Report. Our research partner Moody's Economy.com, produced this report for the EDB.

Highlights from the 2006 Construction Report include:

- Recent conditions in the Sonoma County construction industry are mixed. Residential construction accelerated in the second half of 2005 so that the total number of permits issued exceeded 2004 by about 10%. Nonresidential construction permits issued in 2005, however, did not outnumber issuance in 2004, although the shortfall was modest.
- Overall, however, the industry is in good health. This is indicated by the record high 14,200 workers on construction payrolls, which rose in 2005 for the second consecutive year.
- The housing market appears to be at its peak, with some slowdown in house-price appreciation in last year's fourth quarter. The California Association of Realtors reports that the median sales price for single-family homes in the North Bay peaked in September and fell in each of the subsequent three months. Despite the recent downturn, however, the median sales price remains 10% above the year-end 2004 estimate; exactly equal to the U.S. average trend but somewhat below the 15% rate over the year for California.
- Pressures from the macroeconomy are largely on the downside for Sonoma County's construction industry. These include rising interest rates, rising materials prices, rising labor costs, and little pent-up demand for new housing. Additionally, the Sonoma County economy currently ranks third worst in the nation for housing affordability. This situation undermines both housing demand and the long-term health of the economy.
- Sonoma County builders must still look to the long-term for significantly stronger demand growth. Current excess supply will keep commercial and industrial construction rather light through the coming year. The latter years of this decade, however, will offer more upside potential once the current inventory of industrial and office space is absorbed.

Thank you for your continued interest in the Economic Development Board's research. As always, if you have any questions, please feel free to contact us at (707) 565 - 7170.

Sincerely,

Ben Stone
Executive Director

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Construction Industry - Sonoma County

Recent Trends. Conditions in the Sonoma County construction industry are mixed. Residential construction accelerated in the second half of 2005 so that the total number of permits issued exceeded 2004 by about 10%. The roughly 2,100 permits issued is within a range of rather stable construction activity that has prevailed since 2002, averaging just over 2,000 units permitted for construction each year.

Nonresidential construction permits issued in 2005, however, failed to outnumber issuance in 2004, although the shortfall was modest. Like residential construction, the pace of nonresidential permit issuance has been rather stable since 2002. But in contrast, there was no downturn after the 2001 recession, and nonresidential construction activity remains substantially elevated compared to the years prior to the recession.

The overall good health of the industry is indicated by the number of workers on construction payrolls, which rose last year for the second consecutive year bolstered by the nonresidential market as well as a substantial amount of highway and other infrastructure improvements. Indeed, the 14,200 workers on construction payrolls in the county stands as a record high.

The housing market appears to be at its peak, with some slowdown in house-price appreciation in last year's fourth quarter. The California Association of Realtors reports that the median sales price for single-family homes in the North Bay peaked in September and fell in each of the subsequent three months. Despite the recent downturn, however, the median sales price remains 10% above the year-end 2004 estimate; exactly equal to the U.S. average trend but somewhat below the 15% rate over the year for California.

Most of the gains in homebuilding activity in recent months have been in larger multifamily projects. Single-family construction activity has edged up only modestly through the course of 2005. While this situation partly reflects a limited amount of land entitled for single-family construction, it also highlights the very low affordability in the county's housing market that drives households to multifamily rental or condo units.

After a weak start, nonresidential construction picked up in the latter part of last year but remained low as rising vacancies

in existing office and industrial space dampened demand for new construction, particularly in the office market. Permit issuance for office construction last year was the lowest since 1996. Retail space currently is the strongest; it fell slightly from 2004 but remains at a near record high, now accounting for some 30% of the total value of nonresidential permits issued last year.

Macro Drivers. Pressures from the macroeconomy are largely on the downside for Sonoma County's construction industry. These include rising interest rates, rising materials prices, rising labor costs, and little pent-up demand for new housing.

Rising interest rates pose the greatest threat to the industry as they will dampen demand for new housing. The federal funds rate now stands at 4.5%, up from just 1% in the first half of 2004. Two additional 25-basis point increases are still expected in March and in May. Thus, short-term rates, which drive interest rates on many of the non-traditional mortgage products that are now used to finance homebuying in high-priced markets such as Sonoma County, are rising quickly and are causing affordability to deteriorate further. Higher interest rates have already slowed the pace of home equity extraction through mortgage refinancing. Rising inventories in many areas also are indicative of the impact of higher interest rates nationwide.

Further, long-term interest rates, which drive fixed-rate mortgage rates, are poised to edge higher. Two factors drive these expectations. First, elevated energy prices and increasingly tight labor markets generate potential for higher inflation by the end of this year, which will support higher long-term rates as inflation expectations are priced into the bond market.

Second, the global flow of capital that currently keeps U.S. interest rates low will begin to slow. This is due to an expected easing of oil prices to a still high \$55 per barrel price by the end of the year from today's near-\$60 oil, thus easing the acceleration of petro dollars that get recycled into U.S. bond market. A shift of Chinese dollar savings away from U.S. Treasuries toward tangible assets also should ease some of the downside pressure on long-term rates, allowing them to rise.

Rising materials prices generate some downside potential to the industry at least through the coming year as supplies

of cement, wallboard, and lumber may be in short supply as rebuilding kicks into high gear on the Gulf Coast. Rising construction costs have the potential to generate order cancellations as prices rise beyond expectations.

Similarly, demand for labor is tightening with the U.S. unemployment rate now under 5% and construction labor demand expected to rise on the Gulf Coast, putting pressure on wages. Offsetting this, however, is an expected slowdown in homebuilding elsewhere.

Finally, there is little pent-up demand for housing with the homeownership rate at a near record high and affordability worsening nearly everywhere in the U.S. Indeed, Sonoma County's extremely low affordability rates already lock out a large number of potential home buyers from the local market.

Macroeconomic factors also assert downside pressure on nonresidential markets, but there are some offsetting trends. First, stellar balance sheets of firms within many industries will support investment in structures without the need to borrow in the capital markets, so that higher financing costs are less of a hindrance. Further, very strong profit growth among most industries and high-capacity utilization rates will support investment in equipment and the structures to house them.

Finally, stable global growth will support demand for goods and services from Sonoma County providing stimulus to the local construction industry. This stimulus may come from the very strong demand for travel and tourism services, but also should expand to other industries as well.

Industry Drivers. With both leisure and business travel very strong, and expected to remain that way through the next 18 months, one of the first drivers of the construction industry is likely to be the hotel industry. Bay Area room occupancy rates have risen to post-recession highs and meeting space is at a premium, but hotel construction permit issuance in Sonoma County was near an all-time low in 2005. The industry is expected to meet demand with additional construction over the next several years.

An expected increase in office space-using employment in the near term further supports the construction industry, although this is more of a long-term factor given currently high office vacancy rates.

Construction Industry - Sonoma County

According to Keegan & Coppin Company, the county's office vacancy rate was a very high 21% as of the fourth quarter of 2005, largely due to space vacated recently in Rohnert Park, generating a near 40% vacancy rate for this submarket. At the other end of the spectrum is an office vacancy rate of under 13% in the Santa Rosa submarket. Employment gains in legal, financial, and business service industries of close to 3% annually beginning next year will help generate new demand for office construction.

Conversely commercial/retail space has enjoyed greater demand as the county serves as a retail hub for much of northern California north of the Bay Area, drawing more national retailers to the county. Vacancy rates for retail space have remained at 4% or less over the past two years.

In the near term, demand for space by the public sector and by education and healthcare will support construction activity. Institutional decision making is more independent of the business cycle than that of investors and firms. For example, innovation and the growing ranks of the aged are driving increased consumption of healthcare, which in turn necessitates new equipment and facilities. Also the push by both state and local government to improve existing infrastructure will generate new projects for the construction industry. Supporting this will be the 2005 federal transportation bill, which provides to California \$18 billion for highway projects through 2009, a 40% increase over the previous federal program.

Pricing. Despite the still strong pace of house-price appreciation there is some indication that homebuilders will face an increasingly difficult pricing environment as the year progresses. Some homebuilders in the county report that they still are holding prices steady, but in some instances are offering upgrades and incentives at no extra charge. Given the desirable location of Sonoma County a steep fall-off in prices is unlikely but steady prices and the use of expansive incentive packages may become widespread.

Commercial and industrial builders may face even greater downward pressure on prices due to cost vigilance by both private and public sector clients. Given the large supply of leasing space available, contractors will have to provide very competitive estimates in order to win new projects.

As always, revenue streams will be the strongest for firms with greater transitivity; in other words, with a greater ability to shift from commercial to residential to industrial projects. Such firms would be better able to take advantage of the shifting drivers of the construction industry.

Operating Expenses. Input costs are elevated and will remain above historical averages into the near term with moderation likely setting in the second half of 2006. Strong domestic and global demand has driven the runup in lumber, cement, steel, copper, and petroleum-derived products. Prices of some inputs like steel and lumber have already begun to moderate, though they remain elevated, as supply has risen to meet demand. Copper prices are particularly high.

Additionally, rebuilding in the Gulf region has led to a cement shortage with average prices per ton soaring 13% at the end of last year. Despite a new trade deal with Mexico, which reduces the tariff on Mexican cement by \$23 to \$3 per ton, sustained demand from the Gulf region will keep cement prices above average through 2007.

Labor costs are less problematic, although a moderate gain on average of about 4% per year does put pressure on the bottom line. California's reform of its workers' compensation program is helping the industry. Given the reliance on market mechanisms, however, it is uncertain how long it will be before workers' compensation costs begin to rise once again, putting pressure on firm's expenditures.

Profitability. Profitability will continue to be undermined by elevated input costs and moderating housing demand. Given the increased consumer resistance to price increases, builders may have to absorb a significant share of expenses in lieu of transferring cost increases to buyers. However, contractors who are able to charge for supplies when delivered as opposed to estimating costs of projects ahead will improve their profit outlook.

Long-Term Outlook. Sonoma County builders must still look to the long term for significantly stronger demand growth. Current excess supply will keep commercial and industrial construction rather light through the coming year. The latter years of this decade, however, will offer more upside potential once the current inventory of industrial and office space is absorbed.

The outlook for residential construction over the long term should improve. Demand and supply are very nearly balanced once again in the local economy so that any improvement in employment and income growth should translate into expanded demand for new construction. This should occur more rapidly than the office and industrial market, which still has excess inventory. As long as long-term interest rates rise at a measured pace, their negative impact on the local housing market will be limited. Thus, lack of affordability, rather than a demand-supply imbalance, will be the major constraint to the homebuilding industry.

As rising interest rates work to limit growth of residential construction, so will state and local government fiscal difficulties longer term that may limit growth of public construction. State finances will likely continue to suffer a long-term deficit, although current revenue is running 11% above expectations due to strong corporate tax receipts and improved personal income growth. The current pace of state spending, however, indicates that deficits will continue and there will be a high dependence on federal transportation funding.

Upside Risks. Upside potential arises from the governor's ambitious plan of statewide infrastructure improvements through a comprehensive bond initiative. Despite the risk of deepening the long-term deficit, state government continues to pursue plans for a \$50 billion bond initiative for infrastructure improvement. Much uncertainty remains, but such a program would add to Sonoma County infrastructure projects in coming years.

Downside Risks. Near-term risks are weighted to the downside as the local economy continues to grow at a sluggish pace. Business investment in commercial and industrial facilities may be dampened in late 2006 and early 2007, as the impact of higher interest rates filters more fully through the broader economy. Furthermore, rising mortgage costs may serve to shelve homebuying plans for some consumers in the near term, thus leading to weaker activity on the residential side. Overall, the near term holds moderate prospects for the construction industry.

*Naa Aku Addo
February 2006*

