UHERO Construction Forecast:

Housing-Driven Expansion Reaches Turning Point

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EXECUTIVE SUMMARY

Key Changes in This Forecast.

- Growth in nominal contracting receipts will be stronger this year (20%) than previously expected, although half of the rise simply reflects higher construction costs. The overall slowing trend for the construction sector beginning in 2007 remains largely the same.

- Our full report now breaks out separately permitting activity among residential, nonresidential and government contracts awarded. In addition, we now forecast the Honolulu construction cost index, allowing us to calculate real permit and receipt values that more accurately reflect rising costs.

Hawai‘i’s construction cycle is at a turning point. Residential construction, which has largely driven the recent expansion, will soften as rising costs meet flattening demand. With home appreciation largely over and affordability much eroded, the real volume of residential construction activity will begin to recede gradually. Nonresidential elements of construction will be relatively stronger. The outlook is for gradual slowing; construction employment and earnings are expected to remain near recent peaks for the next several years.

- Construction costs have risen rapidly over the past two years, driven by global spikes in prices of energy, metals and building materials. Commodity prices have begun to ease somewhat recently, and the construction cost surge is likely to moderate over the next several years. Construction cost inflation will recede from more than 10% in the first half of 2006 to less than 5% over the next two years.

- After peaking in 2006–2007, real (inflation adjusted) construction activity will begun a gradual decline. Real residential permitting values have already begun to fall. Real contracting receipts will end 2006 10% higher than in 2005, but will then begin to recede at low single-digit rates. Real construction activity will slow from $6.2 billion constant 2005 dollars this year to less than $6.1 billion in 2007, with further slowing thereafter.

- While real activity is turning the corner, the pass-through of rising construction costs will push nominal (current dollar) contracting receipts upward from $5.6 billion in 2005 to $6.8 billion this year, and to $7.2 billion dollars in 2007.

- The peak in real construction activity will be accompanied by a stabilization in construction employment around a forecast level near 36,000 jobs this year, followed by modest declines in coming years to levels just above 35,000 jobs.

- Home prices more than doubled in Hawai‘i between the late-1990s and first half of 2006, but in our view prices have now reached their upper bound for the current investment cycle. We expect O‘ahu median home prices to peak at an average near $635,000 this year. Home prices are expected to remain just below these levels over the forecast horizon.

- The flattening out of home prices, while income continues to grow, means that home affordability will improve somewhat, but not enough to alleviate the serious affordability problem that the state now faces.

- Comparatively high levels of nonresidential construction will continue for the next several years. Real nonresidential building permit values are expected to peak at just under $1.3 billion constant 2005 dollars this year and fall below $1.2 billion 2005 dollars next year.
Continued tightness in industrial and warehouse inventories provides a strong basis for steady growth in construction of new commercial space. Retail development is expected to remain strong, with the entry of nationally-known brands such as Nordstrom, Target and Whole Foods.

In Hawai‘i’s resort areas, a continuing wave of conversion of existing hotel rooms to condominiums, *condotels*, timeshares and other innovative forms of fractional ownership, is likely to sustain resort construction activity.

The wild card in nonresidential private construction remains the office market. Rising land costs and the dramatic surge in steel and concrete prices have pushed back the probable delivery date for the next wave of Honolulu office towers.

This construction expansion has been marked by an unparalleled dearth of public infrastructure spending. This raises concerns that public commitment to infrastructure investments is falling far short of what is actually needed to support ongoing private development. UHERO forecasts that government construction contracts will hover in the range of $650-850 million constant 2005 dollars annually during the forecast period. Upside risks are O‘ahu mass transit and the possible home-porting of a US nuclear aircraft carrier at Pearl Harbor.
# HAWAI’I CONSTRUCTION FORECAST (SUMMARY)

<table>
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<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
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<td>Nominal GE Contracting Tax Base (Mil $)</td>
<td>4,536</td>
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<td>5,618</td>
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<td>7,156</td>
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<tr>
<td>% Change</td>
<td>6.11</td>
<td>8.49</td>
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<td>GE Contracting Tax Base (Mil 2005$)</td>
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<td>% Change</td>
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<td>2.89</td>
<td>6.34</td>
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<td>Construction Job Count (Thou)</td>
<td>27.94</td>
<td>29.42</td>
<td>33.46</td>
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<td>% Change</td>
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<td>Construction Income (Mil 2005$)</td>
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<td>% Change</td>
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<td>18.78</td>
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<tr>
<td>Honolulu Median Home Price (Thou $)</td>
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<td>457.15</td>
<td>586.53</td>
<td>635.48</td>
<td>625.73</td>
</tr>
<tr>
<td>% Change</td>
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<td>20.93</td>
<td>28.30</td>
<td>8.35</td>
<td>-1.53</td>
</tr>
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* Tax base is deflated by Honolulu Construction Cost Index. Income is deflated by Honolulu CPI. Additional detail available to subscribers and sponsors.
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