


Financial, Real Estate & Creative Industries Insider

2014
SONOMA COUNTY

SONOMA COUNTY
EDB
ECONOMIC DEVELOPMENT BOARD

SONOMA COUNTY
WORKFORCE
INVESTMENT BOARD

2014 Financial, Real Estate & Creative Industries Insider

July 2014

The Sonoma County Economic Development Board (EDB), in partnership with the Sonoma County Workforce Investment Board, is pleased to present the 2014 Financial, Real Estate & Creative Industries Insider for Sonoma County. Our research partner, Moody's Analytics, provided the research for this report.

Highlights of the 2014 Financial, Real Estate & Creative Industries Insider include:

- Sonoma County will remain an attractive location for financial services in the long run. Employment in the industry has returned to positive year-over-year growth starting in 2013.

- The outlook for venture capital investments, the lifeblood for serveral components of the county's creative cluster, is generally positive. The upward trend in tech investment, especially biotech, bodes well for increased demand for local office space.

- Sonoma County's total deliquency rates for all types of credit are now below statewide and U.S. levels. They are projected to continue moving downward or remain constant with the exception of retail.

- Overall, financial services and real estate will generally benefit as the county's economy transitions from recovery to expansion. The creative cluster will also maintain its positive long-term outlook due to its inherent strengths and proximity to Bay Area.

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,

Pamela Chanter
Chair
Economic Development Board

Ben Stone
Executive Director
Economic Development Board

Sonoma County: Financial, Real Estate & Creative Industries

Recent Performance

Sonoma County's recovery solidified near the end of 2013 as core consumer-dependent industries strengthened and a major Indian casino began operations. Hiring for the tribal casino, classified as local government, overstated public sector strength, but hiring by private visitor-dependent industries and business services points to real strengths. The unemployment rate slipped below 6.5% for the first time since the end of 2008, even as the labor force stopped declining. Bolstered by an improving job market, consumer credit conditions in the county are improving. Total delinquency rates for all types of credit are now below statewide and U.S. levels.

Some signs of cooling are visible in real estate. House price appreciation eased at the end of 2013 and early 2014 as sales fell by more than 10% from a year ago, according to the California Association of Realtors. Prices have recovered 45% of their earlier peak-totrough loss, under the 50% statewide recovery. House sales fell more than 2% from a year earlier. Issuance of construction permits has edged upward modestly since the beginning of 2013 but has recovered less than 20% of the peak-to-trough decline experienced from 2006 to 2010. Construction of multifamily units has been the primary driver to date.

Macro Drivers

The U.S. economy grew in 2013 by 1.9%, slightly below the rate forecast at the beginning of the year. A faster recovery was hindered by the continuing failure of political discourse in Washington DC, softness in the housing market at the end of the year, and disappointing performance in emerging markets that may have spooked investors. Although inventory changes accounted for much of last year's growth, the economy surmounted a weak first quarter to achieve steady growth excluding inventories. Household balance sheets have improved and businesses remain highly profitable.

With fundamentals remaining solid, real GDP is expected to rise around 3% in 2014 and accelerate to 4% in 2015 as the economy transitions into expansion. Surging domestic energy production that cuts into imports and helps give manufacturers in the U.S. a cost advantage, and a liquid, well-capitalized financial system will be primary drivers of growth in the near to medium terms. The earlier risk of political brinksmanship in Washington DC has been ameliorated. In its place is the termination of quantitative easing on the part of the Federal Reserve. The Fed must find a way to gracefully increase long-term interest rates in response to continued recovery without hindering a financial sector that is now years removed from a normalized monetary policy.

Developments in the labor market have been mixed. The U.S. unemployment rate has fallen rapidly to 6.6% in January, down from 7.9% a year earlier and the lowest rate since the beginning of the recession in 2008. However, much of this improvement is the result of a lower labor force participation rate, which has recently hit another post-recession low.

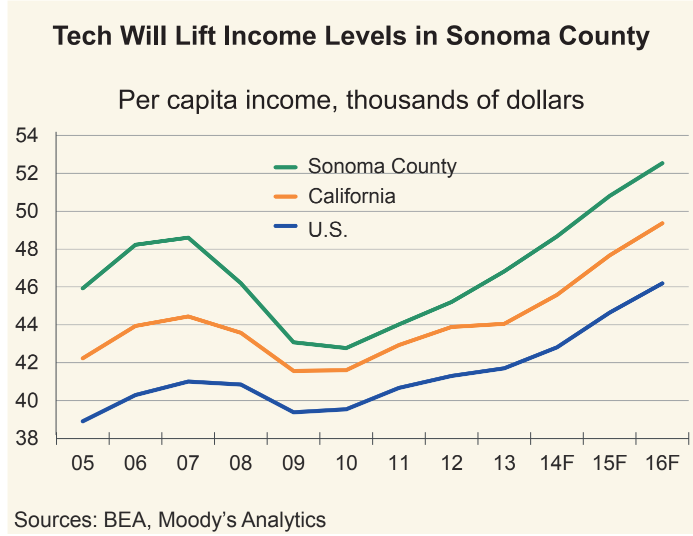

Chart: *Sonoma County will remain an attractive location for financial services in the long run. Population growth over the next several years will remain well above the pace reached during the period of weak growth in the middle of the last decade, when high house prices deterred would-be residents and spurred existing residents to move. In addition, per capita income will grow amid a strengthening recovery and steady growth in high-value-added tech-producing industries. Per capita incomes will remain above both the state and U.S. averages.*

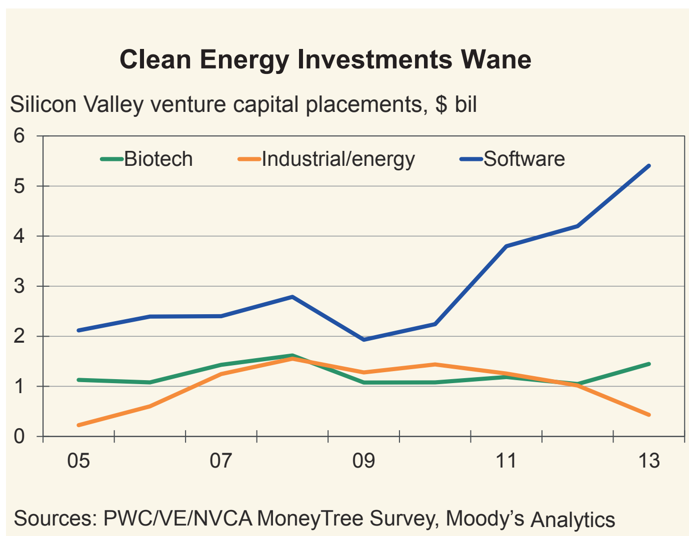

Chart: *The outlook for venture capital investments, the lifeblood for several components of the county's creative cluster, is generally positive. Venture capital placements in Silicon Valley, including Sonoma County, trended upward in 2013 and is now above its 2008 peak. Investments in biotech and software drove most of the growth last year. With federal stimulus spending for clean energy ending, investments in industrial/energy fell to their lowest level since 2005. The upward trend in tech investment, especially biotech, bodes well for increased demand for local office space.*

Net job gains dropped to an average of 100,000 in December and January, half the recent average, but this is thought to have been affected by a combination of unsuitable seasonal adjustments and harsh winter weather. In the wake of faster net job growth, the decline in labor force participation is expected to reverse itself, and the unemployment rate will continue to decline, albeit at a milder rate, and fall below 6% in 2015.

The greatest risks to economic recovery are external. Disappointingly weak growth afflicting emerging markets in general has been joined by pronounced political turmoil in a few. Although the direct impact on the U.S. is minimal, there is a potential for financial panic that could scare skittish investors, spread to other emerging markets, and affect the developed world. Aggressive actions by the European Central Bank averted the threat of renewed crisis in the euro zone, and confidence in the stability of its financial and monetary systems subsequently improved. Nonetheless, the ECB's tight monetary stance is supporting an overvalued euro, low inflation—even deflation in some member states—and sluggish recovery. This raises the worry that unexpectedly poor growth in 2014 could precipitate another crisis in more debt burdened countries.

Financial Services

After five years of an unchanged federal funds rate, some uncertainty has been introduced into the outlook. The Federal Reserve issued guidance in January that it will not raise interest rates while the unemployment rate is above 6.5% and inflation expectations are not higher than 2.5%. However, the sharp fall in the unemployment rate to 6.6% in January makes it likely that it will soon drop below the Federal Reserve's threshold, at which point the Fed will weigh its assessment of the labor market against its as-assessment of inflation. Both the total and core personal consumption expenditure index remain below 1.2%, more than a percentage point below the Fed's latest upper bound for inflation. New Chair Janet Yellen has indicated a greater willingness to accept higher inflation in exchange for faster improvement in the labor market and explicitly stated that the inflation target is not a ceiling, thus lowering expectations as to how quickly the Fed will raise rates.

Regardless of changes in the federal funds rate, the gradual winding down of quantitative easing will have an effect on long-term interest rates. Tapering of the Federal Reserve's bond-buying program is not expected to panic investors, who have been reassured by clearer guidance after being alarmed by speculation in the summer. The Fed is expected to raise the 10-year Treasury yield to 3.75%, up 90 basis points from the January average.

Sonoma County's financial institutions are slowly strengthening in the aftermath of a deep recession and housing crisis. Santa Rosa-based Exchange Bank, the county's largest community bank, reported a 28% increase in earnings in 2013 in large part because of a reduced loan loss provision. Strengthening balance sheets for Exchange Bank and other local financial institutions are a result of improving balance sheets for county businesses and consumers. Business and personal bankruptcy filings on a per capita basis have fallen from their recession peaks and are now at U.S. levels for the first time since 2000. Delinquency rates of all types of consumer and mortgage loans will also move downward or remain constant with the exception of retail.

Real Estate

The housing market in Sonoma County is on a slow mend. House prices have yet to reach their prerecession and housing peak but have regained more than 70% of their peak-to-trough decline. This compares with recoveries of 57% statewide and 62% nationally. Helping to bolster house prices is a sharp drop in the local foreclosure rate, now below the U.S. level. Amid rising mortgage interest rates and diminishing housing affordability, the year-over-year pace of house price gains will cool in 2014 and 2015 but will still beat that of California and the U.S.

The issuance of residential construction permits in Sonoma County will strengthen as pent-up demand for housing is unleashed. The rate of permitting will accelerate in 2014 and will peak by the end of 2016 at a rate above the previous peak level reached at the end of 2004. The looming improvement in residential construction will help to boost construction employment, which has yet to begin recovery after losing more than two-fifths of employment from its prerecession peak.

The market for office space will not experience much improvement in 2014. Although office-using employment regained 1,000 jobs in 2013, payrolls remains one-sixth below their prerecession peak and are expected to grow only sluggishly over the next two years. The office vacancy rate, according to Keegan & Coppin Co., finally experienced sustained improvement in 2013 and is now at its lowest since the recession despite remaining above 20%. Even Rohnert Park's vacancy rate plummeted from 52% in the second quarter of 2013 to 33% in the fourth quarter of 2013, although much of this decline resulted from the residential redevelopment of the vacant State Farm Insurance regional headquarters rather than an increase in leased space.

Industrial space is making a more rapid recovery. After peaking at 15% in the first quarter of 2012, the industrial vacancy rate has decreased over seven consecutive quarters and now stands a 10%. Improvement has been especially strong in the North Corridor, where traffic at the Charles M. Schulz–Sonoma County Airport has surpassed prerecession levels in flights and passengers. With another bumper crop of grapes in 2013 following a record harvest in 2012, large inventories will strain the supply of wine storage tanks and space to store them.

Moody's Analytics Financial, Real Estate & Creative Industries

The retail market has remained strong, with a vacancy rate of 4.7%, well below the 2009 peak above 9%. The 320,000-squarefoot Graton Rancheria Casino opened in November and features, in addition to slots and table games, several restaurants and a concert center, establishing a major tourist attraction in Rohnert Park. With the county's economy expected to recover robustly over the next few years and with balance sheets improving, consumer spending should follow suit and demand for retail space will remain strong.

Insurance

Insurers operating in Sonoma County will continue to adapt to federal healthcare reforms. The mandate for employers to provide health insurance to their workers, or pay a fine, has been delayed to 2015 for large employers and further for smaller employers. Even with the delay, more than a third of statewide companies plan on increasing premiums and deductibles that their employees must pay in 2014, according to the California Healthcare Foundation.

Predictions of drought and depleting water levels in 2014 led to a rush by Sonoma County vineyards to obtain federally subsidized crop insurance prior to the January 31 deadline. Local banks reported an increase in crop insurance premiums to cover up to 80% of vineyard crops rather than the typical 50% to 60% coverage. Insurance payouts would help to prevent a sharp drop in local farm incomes if vineyards lose a large share of the 2014 vintage harvest to drought.

Creative Cluster

The outlook for Sonoma County's creative cluster of industries, which includes creative arts, technology services, and related professional services, is modestly bright. The cluster's components of science and engineering, architecture and design, management and finance, education, and arts, music and entertainment dipped to 5% of total county employment over the past year, the lowest level since 2002. The share is slightly more than half the state average but remains well above the 1% national average.

Decreases in the ranks of business service providers such as accountants offset increases in computer system designers and other professional, scientific, and technical services providers. The decision by Agilent Technologies to spin off its Santa Rosa-based electronic measurement division introduces some near- to long-term uncertainty for the county's cluster of creative industries.

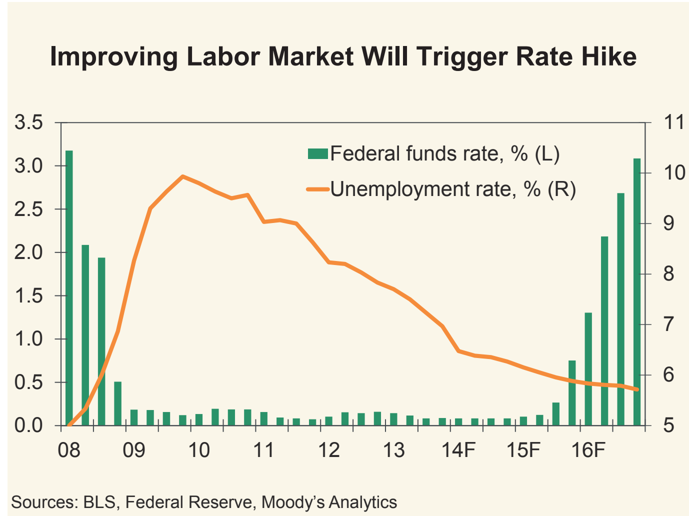

Chart: *The Federal Reserve will begin to raise interest rates by 2016 in response to a strengthening economy. The Fed has clarified earlier guidance as to what factors will prompt an end to its purchase of mortgage-backed securities and other quantitative easing measures, as recent declines in the U.S. unemployment rate have largely been the result of a still-declining labor force participation rate. The Moody's Analytics baseline forecast is for the Federal Funds rate to begin rising by the end of 2015 when the U.S. economy should be in full, if belated, expansion.*

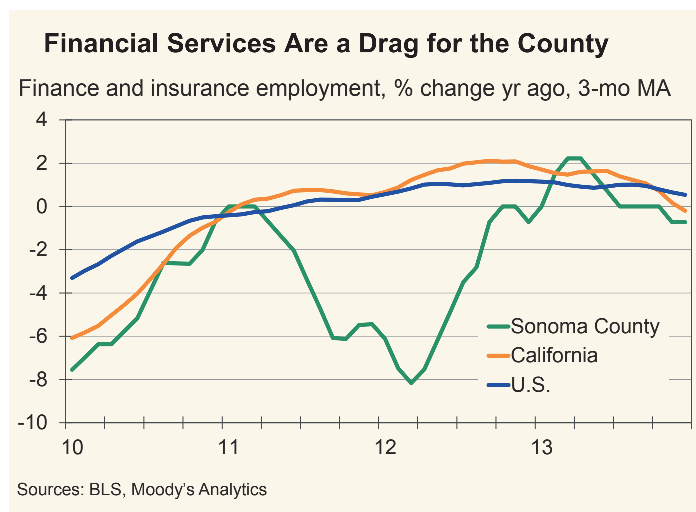

Chart: *Financial services will remain a sizable weight for Sonoma County in the near term. Employment in the industry returned to positive year-over-year growth in the beginning of 2013 for the first time following the departure of the State Farm Insurance headquarters in 2011. However, rising mortgage interest rates beginning in the summer of 2013 triggered locally based and national financial service firms to scale back their staffing of mortgage refinancing offices in the county. The outlook for an increase in new-home construction should help to bolster mortgage related employment.*

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Long-Term Outlook

Financial services and real estate will generally benefit as the county's economy transitions from recovery to expansion. However, long-term growth will be modest relative to the high rate during the tech boom a decade ago and the period prior to the recent recession. The modest rate of growth will be more in line with Sonoma County's projection of moderate population gains in the long term.

The creative cluster maintains its generally positive long-term outlook, given its inherent strengths and its position in the larger California economy. Sonoma County's climate, quality of life, proximity to Bay Area urban centers, nearby technology centers and universities, and abundant recreational opportunities all support a positive longterm outlook. These factors will contribute to the area's ability to attract a highly educated and innovative workforce, as well as new investments, as the U.S. economy transitions from recovery into expansion. High-value-added life science and energy-related technologies offer particularly good potential for the future.

Upside Risks

Strong growth in developing Asia—China and India in particular—represents a major upside risk for the county's finance, insurance, real estate and creative cluster industries. As more citizens of developing economies enter the middle class and as firms in these countries seek IT and other capital equipment, demand for the tech products designed in Sonoma County will rise. This will boost demand for new tech-related office space in addition to further bolstering the strongest component of Sonoma County's creative cluster.

The spin-off of Agilent's local electronic measurement division introduces some upside risk in the form of new businesses and product lines as well as the hiring of managers and other staff at the Santa Rosa headquarters. The new division, renamed Keysight Technologies, could help to fill in part of the hole left by the departure of companies from Sonoma County in recent years, including State Farm Insurance in 2011.

Downside Risks

A sharp rise in mortgage interest rates and further loss of housing affordability are negative risks for Sonoma County's real estate-dependent industries. A robust acceleration in U.S. and global economic growth, a distant risk for now, would lead the Federal Reserve to end its quantitative easing programs sooner than expected, causing borrowing costs for would-be homebuyers to rise. This would discourage firsttime buyers from purchasing in the county and push many to lower-cost areas of the Bay Area and the Central San Joaquin Valley.

The spin-off of Agilent Technologies' local division also introduces some downside risks. The division has been impacted by consumers' and businesses' shifting preferences away from personal computers toward tablet computers and smartphones. Keystone Technologies will need to adjust to this changing technology landscape just as Bay Area semiconductor companies have. While the tech firm may expand its headquarter presence in the immediate near term, Keystone may decide to shift some production and development to lower-cost areas in the U.S. or overseas.

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Moody's Analytics

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With acknowledgement and appreciation to key local businesses that support economic development in Sonoma County

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