Financial, Real Estate & Creative Industries Insider

2015
SONOMA COUNTY

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EDB
ECONOMIC DEVELOPMENT BOARD

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WORKFORCE
INVESTMENT BOARD

2015 Financial, Real Estate & Creative Industries Insider

The Sonoma County Economic Development Board (EDB), in partnership with the Sonoma County Workforce Investment Board, is pleased to present the 2015 Financial, Real Estate & Creative Industries Insider for Sonoma County. Our research partner, Moody's Analytics, provided the research for this report.

Highlights of the 2015 Financial, Real Estate & Creative Industries Insider include:

- Sonoma County will remain an attractive location for financial services in the long run. As the state and national recoveries gather steam, the county's high share of mid-wage jobs will boost commercial bank lending, and demand for other financial services will follow suit.

- The market for commercial real estate tightened in 2014. Office vacancy rates fell to their lowest level since the recession as officeusing employers ramped up hiring. The upward trend in tech investment, especially biotech, bodes well for increased demand for local office space.

- A recovering U.S. economy has brightened the outlook for Sonoma County's creative cluster of industries. The cluster's components of science and engineering, architecture and design, management and finance, education, and arts, music and entertainment have begun to recover after dipping to 5% of total employment in 2013.

- Overall, A stronger than expected national recovery, fueled by a prolonged period of low oil prices, also provides upside potential. Greater disposable income for U.S. households means that the main Sonoma County beneficiaries, the wine and beer industries and leisure/hospitality, will provide greater contributions to the local economy.

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 economy is slowly rebounding from an earlier softening and is now closely tracking the national pace. Overall payroll employment gains are still above average, and the pace of hiring is robust. The unemployment rate has fallen even as more workers returned to the labor force. The jobless rate reached 5% in November, well below average and the low.

While hourly earnings growth remains weak and home sales are slowing, lower fourth quarter office and industrial vacancy rates hint that businesses are growing more upbeat. A stronger job market has yet to lift income growth, but recent gains have helped strengthen consumer credit.

Sonoma County's real estate market experienced a slight downshift in 2014. Although house price appreciation advanced at a steady clip, sales of existing homes slowed substantially. According to the California Association of Realtors, median house prices have recovered nearly 70% of their peak-to-trough loss, well ahead of the statewide average of 57%. However, new-home sales hit their lowest point since the recession as interest rate uncertainty weighed on demand. Issuance of construction permits fell sharply in the second half of 2014, ending the year at less than 15% of their prerecession peak. Multifamily units continued to be the primary driver of residential construction.

Macro Drivers

After a weak first quarter, the U.S. economy bounced back over the course of 2014, pushing growth north of the 2013 rate. Perhaps the most significant development of the year was the rapid decline in joblessness, bringing the U.S. economy closer to full employment. Household balance sheets grew healthier and businesses remained highly profitable. Fading fiscal drag from prior federal spending cuts was also a positive, but a disappointing housing market recovery and lackluster growth in emerging markets have created some friction. Nonetheless, all ingredients are in place for stronger growth in 2015. Moody's Analytics forecasts real GDP growth of 3.7% this year. A better economic environment should also boost wage growth and help the U.S. economy achieve full employment by mid-2016.

A somewhat surprising development with a measurable impact is the sudden decline in oil prices. Although lower oil prices may cause some U.S. oil producers to curtail their production levels this year, cheaper energy is helping both energy-intensive industries and consumers, resulting in a net positive for the economy.

With both the drag from federal spending cuts fading and the end to the Federal Reserve's quantitative easing, the economy is taking advantage of low interest rates and growth is shifting into high gear. The labor market is clearly in a better place than a year ago. Monthly job creation has averaged over 280,000 in the past six months and has helped bring the U.S. unemployment rate down to 5.7% in January.

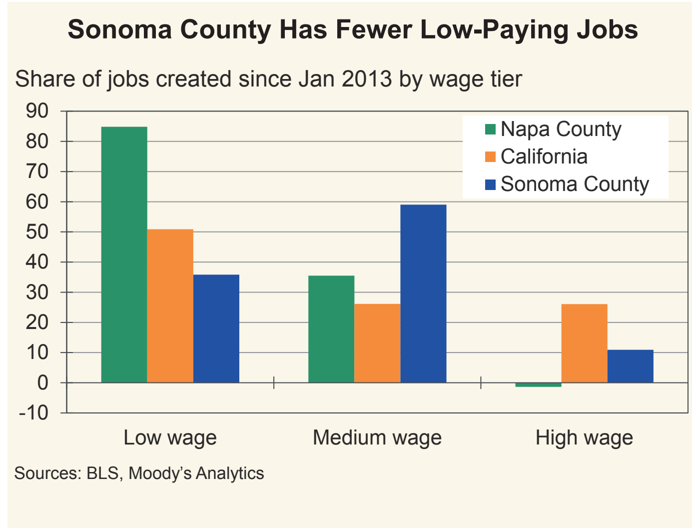

Chart: *Sonoma County will remain as an attractive location for financial services in the long run. As the state and national recoveries gather steam, the county's high share of mid-wage jobs will boost commercial bank lending, and demand for other financial services will follow suit. The county's large retiree cohort will also lift demand for asset management and insurance products. Steady growth in mid-tier wage positions such as tech manufacturing, healthcare, and upscale tourism will keep per capita incomes above state and U.S. averages.*

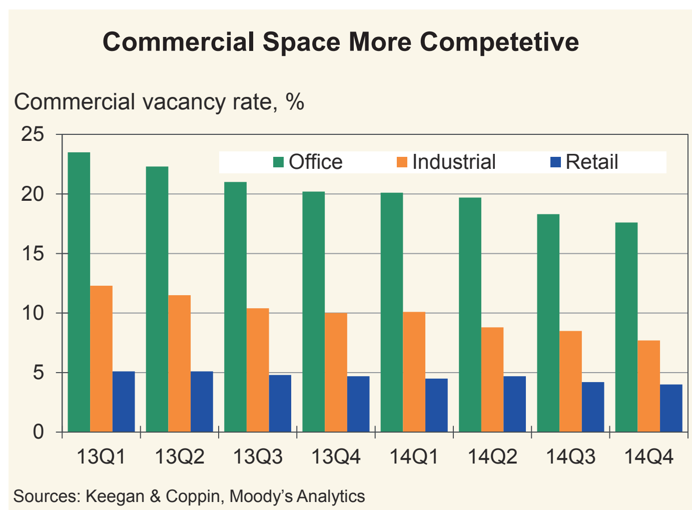

Chart: *The market for commercial real estate tightened in 2014. Office vacancy rates fell to their lowest level since the recession as office-using employees ramped up hiring. In 2015, downtown Santa Rosa will welcome its first new office building in 10 years. While further construction growth will be largely limited to health service providers, vacancy rates will drop further as business investment rises and the national recovery gathers pace. The upward trend in tech investment, especially biotech, bodes well for increased demand for local office space.*

Household formation has fallen short of expectations, slowing the housing market's recovery. As millennials start forming households at a faster clip, the housing market will grow stronger and support overall growth. However, a gradual rise in long-term interest rates will be the key to keeping the housing recovery on track. Policymakers have gained valuable experience in communicating with financial markets. Yet the process of normalizing monetary policy may not be as graceful as hoped and continues to be a significant risk.T

The global outlook is also of great importance for the U.S. economy. Lackluster growth in emerging markets and political turmoil elsewhere remain factors that cannot be ignored. The threat of deflation in Europe is still real and is indicative of significant weakness there. A soft global economy coupled with a stronger dollar will take a bite out of exports and juice up imports, at manufacturers' expense.

Financial Services

After six years of near-zero interest rates, the question of when and how fast the Federal Reserve will raise the federal funds rate lends a good deal of uncertainty to the outlook. Fed Chair Janet Yellen communicated in January that the Fed's first rate hike will not come before the institution's June policy meeting, although slow wage growth and below-target inflation could delay a final decision until fall.

Uncertainty over the Fed's next move has clouded the picture for longer-term rates. Despite the end of quantitative easing, the Fed's $4 trillion balance sheet and the European Central Bank's own quantitative easing program will weigh on long-term yields. While lower long-term interest rates will boost consumer spending and business investment, if they do not rise in step with the federal funds rate, smaller banks that rely primarily on deposits could see profits squeezed.

Despite these challenges, Sonoma County's financial institutions strengthened in 2014. Santa Rosa-based Exchange Bank, the largest community bank in Sonoma County, reported a 15% increase in earnings through the third quarter of 2014, while 2014 earnings at Summit State Bank, also headquartered in Sonoma, surged by 27%. Improved asset quality and steady loan growth at Exchange Bank and other local financial institutions reflect continued improvement in household and business balance sheets. According to Equifax, delinquency rates for auto, bank, and credit card loans have fallen to pre-recession levels and remain well below state and national averages.

Real Estate

The housing market in Sonoma County began to cool in 2014 and early 2015, although existing-home sales outpaced those in neighboring Napa county. According to the California Association of Realtors, median house prices rose by 12%, faster than the state and national averages, but slower than the previous year's pace of 23%. Although house prices have recovered nearly 70% of their prerecession peak, slower income growth, supply constraints, and uncertainty over the future path of interest rates held back sales. Still, house price gains will beat those of California and the U.S. in the next two years.

The pace of homebuilding in Sonoma County will accelerate in 2015 as pent-up demand is unleashed. The accompanying improvement in residential construction will boost overall construction employment, which remains more than 80% below its prerecession peak.

The market for office space will tighten as national and local businesses expand their footprints in Sonoma County. The office vacancy rate, according to Keegan and Coppin Co., fell below 20% in the second quarter of 2014 for the first time since the recession, reflecting strong gains in office-using employment. Downtown Santa Rosa will welcome its first new office building in more than 10 years as construction concludes at the Museum on the Square complex, which will serve as headquarters for the Santa Rosa-based Luther Burbank Savings Bank and the soon-to-open California Wine Museum. Infrastructure improvements at the Charles M. Schulz-Sonoma County Airport will make office space more attractive in the North Corridor area. New tenants include Brazilian aircraft manufacturer Embraer Executive Jets, which has leased space for its regional headquarters near the airport.

Competition for industrial space intensified in 2014. The industrial vacancy rate fell to a new post-recession low of 7% as local manufacturers and health service providers expanded into new facilities. Planet One Products, a maker of appliances and accessories for wine storage, moved its headquarters to the vacated Cisco Systems building in Petaluma, more than doubling the size of its production and warehouse space. The expansion of the healthcare industry will spur new construction as the Sutter Santa Rosa Regional Hospital and Kaiser Permanente open new treatment centers.

The performance of the retail market was even stronger. At 4%, the retail vacancy rate is at its lowest point since 2008, bolstered by a flurry of leasing activity. While big box retailers like Target and Dick's Sporting Goods led the way, small businesses also expanded into existing space, including native son Williams Sonoma, which re-opened at its very first location in Sonoma County in October 2014. Low vacancy rates are also driving new construction. The Deer Creek Village shopping complex, one of two new malls opened in the last two years, will create additional space for retailers when its second phase is completed in the fall of 2015.

Insurance

Health insurers operating in Sonoma County will need more time to fine-tune their operations and adapt to Affordable Care Act regulations. Kaiser Permanente, the county's largest employer, is the top performer in the state because it is retaining 99% of its Covered California 2014 customers. Other insurers are also seeing high retention rates and have new customers signed up. The individual mandate penalties get steeper over time for the uninsured, and many of those who lacked coverage in 2014 are now insured, helping to grow the insurance pool. The premium increases are only modest in 2015 as competition and regulations have capped rate hikes. However, an ACA rate review requirement coupled with a rule mandating insurers to spend 80 cents out of every premium dollar on health services, or provide customers with refunds, will limit industry gains.

Meanwhile, the mandate for employers to provide health insurance to their workers or pay a fine took effect early this year for large employers and has been delayed until 2016 for smaller employers. The impact is yet to be seen, but employer opposition to the mandate remains high.

On another front, the expectation of a prolonged drought prompted many busi-nesses to get federally subsidized coverage in 2014 and others to upgrade their policies to cover up to 80% of the losses. The August earthquake may present another opportunity for local insurers. Only 10% of the county's homeowners have earthquake insurance, according to the California Earthquake Authority, and fear of future quakes may boost the insurance market.

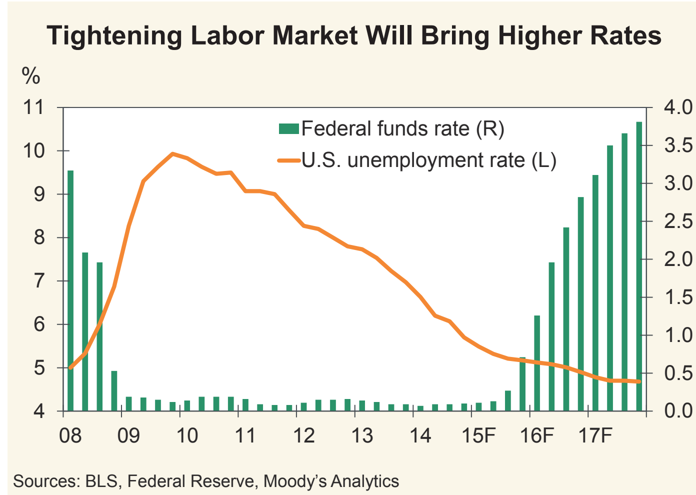

Chart: *The Federal Reserve will begin to raise interest rates by 2016 in response to a strengthening economy. Despite ending monthly asset purchases under quantitative easing, the Fed has pointed to slow wage growth and low inflation in an attempt to clarify its guidance over the path of the federal funds rate, held at near0zero levels for almost six years. 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.*

Creative Cluster

A recovering U.S. economy has brightened the outlook for Sonoma County's creative cluster of industries. The cluster's components of science and engineering, architecture and design, management and finance, education, and arts, music and entertainment have begun to recover after dipping to 5% of total employment in 2013, the lowest level since 2002. As household balance sheets recover and business investment increases, employment growth in these industries will outpace total employment in the county, although the share of these industries in total employment will remain below the state and national averages.

In 2014, slower hiring in business service providers such as legal firms and accountants was offset by robust growth in computer system design and other professional, scientific, and technical service providers. While the split of Keysight Technologies from parent company Agilent introduces some uncertainty into the outlook for tech employment, local artists, musicians, and other creative professionals will be bolstered by the launch of Creative Sonoma, a local council to promote the arts, as well as the county's burgeoning film industry.

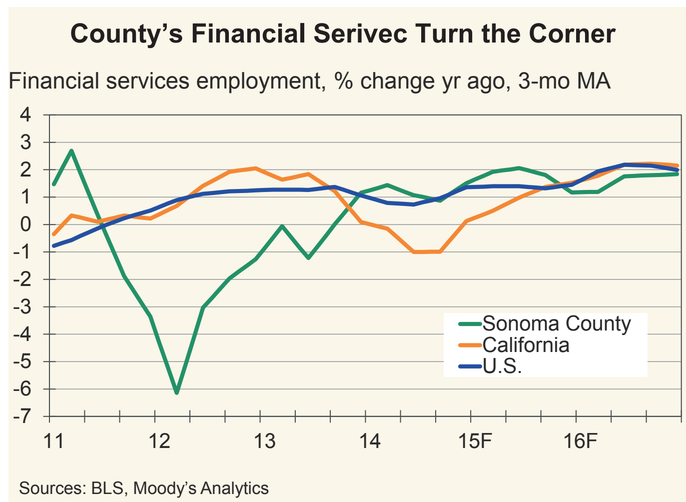

Chart: *Strong earnings growth at Sonoma County-based financial institutions will lift finance and insurance employment over the next two years. The sector has struggled since the closure of State Farm Insurance's regional headquarters in 2011, while the mid-2013 spike in mortgage interest rates added further strain. However, strengthening household and business sheets will drive a rebound in demand for financial services, boosting earnings and returning the sector to growth. Finance, insurance and real estate payrolls will grow by nearly 2% in 2015 and 2016.*

Long-Term Outlook

Sonoma County's real estate and financial services will benefit from a stronger recovery, but the timing of such gains will be different. While real estate will see stronger gains this year, financial services will be plagued by uncertainty throughout 2015 as the Fed prepares to raise interest rates. As the county's financial institutions adapt to rising interest rates, hiring will pick up in late 2016 and emerge as a key driver of the local economy.

Sonoma County's low business costs relative to the rest of the Bay Area, large pool of skilled labor, and burgeoning biotech, information systems, and film industries bode well for the county's creative cluster. Although employment in semiconductor and electronic device manufacturing has fallen below its dot-com era peak, the share of electronics manufacturing in total employment is still twice the national average. Sonoma County's motion picture industry will receive a boost by the recent launch of Culture Pop Industries, a local collective of photographers, film makers, and producers that has produced television series for several outlets, including the Food Network.

Upside Risks

A stronger than expected increase in external demand, stemming from stronger growth in east Asian economies, represents an upside risk for the county's finance, insurance, real estate and creative cluster. Larger, more established firms such as Keysight Technologies and Medtronic Cardio Vascular would be the main beneficiaries of a surge in external demand, but gains would spill over to the area's specialty life sciences firms and local wine producers.

A stronger than expected national recovery, fueled by a prolonged period of low oil prices, also provides upside potential. Greater disposable income for U.S. households means that the main Sonoma County beneficiaries, the wine and beer industries and leisure/hospitality, will provide greater contributions to the local economy. The best wine vintage in years, 2014, adds more momentum to such an upbeat scenario. New trade treaties, likely to be signed into law this year, would also provide upside potential, as they would open more markets to area medical device manufacturers and vintners.

Downside Risks

The most significant downside risk to the outlook is the uncertainty around the Fed's normalization of monetary policy. The timing of an increase in the federal funds rate and a rise in long-term rates could further stall the county's housing recovery. Higher long-term interest rates would increase borrowing costs, undermine affordability, and depress loan applications. This would be particularly problematic for would-be homebuyers, causing them to consider relocating outside the county and buy in places offering more affordable housing.

While the wage differential between the U.S. and emerging Asia has narrowed, offshoring remains a source of downside risk, especially as emerging market manufacturers scale the value-added chain. If Sonoma's electronics and medical device manufacturers shift more jobs to lower-cost destinations overseas, job creation, especially in the mid-wage tier would suffer, stunting the growth of Sonoma's economy.

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

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