



INDUSTRY INSIDER
**FINANCE, REAL ESTATE
& CREATIVE INDUSTRIES**

INDUSTRY REPORT

2017



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EXECUTIVE SUMMARY

February 2017

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

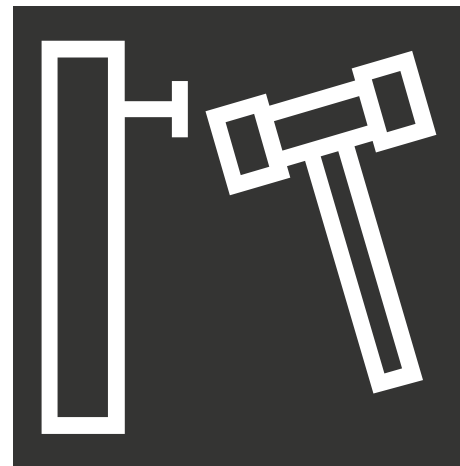
HIGHLIGHTS



Sonoma County's financial institutions have thrived by extending credit to the rapidly growing food manufacturing and winemaking industries. Furthermore, the profitability of financial institutions will improve as the Fed continues to tighten monetary policy by raising interest rates. Adding even more to financial institution profits, strong personal income gains have increased demand for consumer lending and lines of credit. However, increased earnings are not expected to translate into a large increase in industry employment.



The housing market is experiencing a strong recovery and will end this year with the first sustained increase in single-family homebuilding in more than a decade. Median home prices are just below the prerecession peak, and increased at twice the national rate. Rising home values are prompting more homeowners to list and spurring new construction, both of which relieve the tight selection of homes for sale. Construction of single-family homes will let some of the steam out of the apartment market.



Commercial property markets are experiencing multidecade lows. Falling vacancy rates are spurring new construction, especially in the Santa Rosa, Rohnert Park, and Petaluma submarkets. Although there is sufficient office space to absorb new demand, the industrial and retail markets are approaching critical tightness. The robust tourism industry keeps retail vacancy rates low, and food and beverage manufacturers, including winemakers, compete for existing industrial space, encouraging some producers to invest in new facilities.

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.



Recent Performance. Sonoma County is easing off the accelerator after outpacing California's other midsize metro areas for much of the past two years. Though pivotal winemaking, food manufacturing, tourism and technology industries remain potent drivers, the economy is settling into a more modest pace of expansion as the labor market nears full employment and the pool of idle workers thins. Not only has the jobless rate fallen to its lowest point since the height of the tech boom in the late 1990s, but the ratio of total employment to the working-age population, which includes workers who are not actively seeking employment, is at a record high, a sign that slack in the labor market is increasingly spare.

Greater competition for workers is lifting wages. According to the Quarterly Census of Employment and Wages, average weekly pay rose swiftly over the past year and is steadily narrowing the gap with the U.S. average.

The residential real estate market has at last found its bearings. House prices have recovered nearly all of the ground lost in the recession, and resurgent demand is stimulating new construction. Despite historically tight inventories, new- and existing-home sales are on the rise, and construction of new single-family homes has turned up for the first time since the housing market bottomed in 2010. Though rapid house price gains are straining affordability, better wage growth is enabling more households to take the plunge into homeownership. Commercial real estate prices are also firming as county food and winemakers, hospitality operators, and retailers set forth with plans for expansion.

Macro drivers. The U.S. economy turned in a better performance in the second half of 2016 and is poised to strengthen this year as business equipment spending firms and the housing market recovery hits full stride. The strong dollar will remain a spoiler as monetary easing in Japan and Europe and higher interest rates in the U.S. extend the greenback's run, but the revival in domestic energy production and increased residential investment will offset much of the drag from trade. Moody's Analytics calls for the economy to expand just north of 3% this year as better wage gains support consumer spending and nudge businesses to spend more on labor-saving technologies.

Trade and fiscal policies favored by the Trump administration introduce considerable uncertainty into the outlook and increase the

odds that the economy will exceed its long-run potential growth rate later this year. The baseline outlook assumes that tax cuts and infrastructure spending proposed by the new administration will lift growth by 0.5 percentage point in the second half of the year. With the economy operating close to full capacity, the additional demand will stir cost pressures and could prompt a more aggressive response from the Federal Reserve. If the Fed raises interest rates more quickly than markets expect, the resulting repricing of risk will disquiet markets and startle investors, causing businesses to slow hiring and postpone capital expenditures.

Protectionist policies advanced by the new administration are not fully fleshed out but could deal a larger setback to the economy. While new tariffs proposed on foreign-made goods would likely be passed along to consumers in the form of higher prices, a potential pullback from existing trade agreements could discharge a substantial shock to the economy by disrupting global supply chains. Production and design in high-tech industries, which crisscrosses international borders, would be especially hard-hit.

Financial services. After raising interest rates in December for just the second time in 10 years, the Federal Reserve will resume the course of monetary normalization this year. Higher short-term rates pose little threat to the economy since consumers and businesses have already moved to lock in lower rates, but a steeper yield curve will raise margins on new loans. Some of this gain will fade in the face of ample global liquidity. However, even though capital inflows will press down long-term rates, financial institutions' profitability will improve as the Fed's tightening cycle runs its course.

Despite the long stretch of near-zero interest rates, Sonoma County's financial institutions have thrived by extending credit to the rapidly growing food manufacturing and winemaking industries. Assets under management at Santa Rosa-based Exchange Bank, the largest community bank in Sonoma County, surged by nearly a quarter over the past two years to \$2.2 billion, while net income increased more than one-fifth over the same period. Summit State Bank, Sonoma County's second-largest bank by assets, also chalked up steady gains in asset and loan volumes.

Robust personal income gains have increased demand for consumer lending.

According to Equifax, outstanding balances for auto, bankcard and mortgage credit rose 3% over the past year, about even with the economy's estimated rate of expansion. Consumer credit quality is close to pristine, and delinquency rates continue to decline across loan segments after returning to prerecession levels early last year. However, while sturdy demand for credit will aid profits, increased earnings will not translate into a large increase in industry employment. New mortgage lending, a key source of asset growth in previous expansions, will expand at a more moderate pace as slower in-migration tempers potential housing demand.

Real estate. The housing market in Sonoma County is off and running and will cap this year with the first sustained increase in single-family homebuilding in more than a decade. According to the California Association of Realtors, median house prices stand at the cusp of their prerecession peak and are increasing at nearly twice the national rate. Rising home values will encourage more homeowners to list, helping to relieve the tight selection of existing homes for sale and to spur new construction.

Permits for new single-family homes surged in the second half of 2016 and ended the year at an eight-year high. Increased single-family construction will let some of the steam out of the apartment market, which has absorbed the bulk of household formation in recent years.

Despite the positive near-term outlook for residential construction, the steep decline in housing affordability is cause for concern and will keep housing demand well below levels reached in previous expansions. According to the Moody's Analytics Housing Affordability Index, which measures the share of median family income required to purchase a median-priced home, housing costs are among the highest of midsize California metro areas.

Commercial developers broke ground on several new projects in 2016, and competition for new commercial space will intensify as Sonoma County food manufacturers, winemakers and hospitality firms expand. Vacancy rates for office, industrial and retail space are hovering at multidecade lows, according to Keegan & Coppin Co., and falling vacancy rates in the busy Santa Rosa, Rohnert Park and Petaluma submarkets are spurring new construction. Downtown Santa Rosa welcomed its first new office building in more than a decade with the completion

of the Museum on the Square complex, a multi-use facility that will host the California Wine Museum and new headquarters of Santa Rosa-based Luther Burbank Savings Bank. Healthcare providers and boutique financial services firms will drive additional construction and leasing activity. San Francisco-based lender FIS Mobile recently opened a satellite office in Petaluma, and Vendini, a ticket services startup, also acquired new office space.

With vacant industrial space in increasingly short supply, county food and beverage producers will invest more aggressively in new production facilities. For example, Russian River Brewing Co. will break ground on a 90,000-square-foot brewery and taproom in Santa Rosa this year, and artisanal food makers Miyoko's Creamery, New Barn and Amy's Kitchen recently completed capacity additions that will serve as a springboard to national supermarkets and discount wholesalers.

The bustling tourism industry will keep vacancy rates for retail space low. New shopping centers such as the Deer Creek complex are filling quickly, and the revival of downtown Healdsburg and Santa Rosa will pave the way for new restaurants, hotels, and other hospitality establishments to fill vacant space.

Insurance. An aging population will provide Sonoma County health insurers with a steady source of demand. However, rising premiums could push younger residents to seek lower-cost plans or to exit the market entirely, straining insurers' ability to offer plans through the state healthcare exchange. After two years of modest increases, average premiums for plans offered over the state exchange will rise by 13% in 2017, according to Covered California.

Congressional repeal of the Affordable Care Act is a distinct possibility now that ACA opponents stand at the helm of both the executive and legislative branches. However, plans to replace the individual mandate—the centerpiece of the act—have yet to materialize. Barring an orderly process to replace or modify the act, insurance markets could experience substantial volatility, hampering profits for local providers.

Prolonged dry conditions will present an opportunity for another local insurance segment: crop insurers. Many wine grape growers took advantage of federal subsidies to upgrade their insurance policies in recent years, and the extension of federal subsidies will benefit local providers of crop insur-

ance such as Santa Rosa-based American Ag Credit.

Creative cluster. Sonoma County is quickly emerging as an important design hub for athletic apparel, outdoor sports equipment, and ethically sourced consumer goods. However, the outlook for the creative cluster of industries has grown more cautious in light of the prolonged stagnation in tech-related professional services. Employment in high-paying software publishing, computer systems design, and biomedical research has barely budged over the past five years, in contrast to the swift resurgence in the San Francisco Bay Area. These industries, which make up more than half of total cluster employment and wages, will add few new workers over the coming years, as Sonoma's top tech and medical device firms favor low-cost locations in the U.S. and overseas.

The relocation of apparel giant Athleta to San Francisco this year casts further doubt on the creative cluster's ability to drive long-run employment and income gains. However, some of the blow will be offset by growth in other local apparel manufacturers such as Indigenous and Farm Fresh Clothing. Meanwhile, outdoor equipment firm Camelbak's decision to remain in Sonoma County after its acquisition by Vista Outdoor late last year will place a floor under demand for design professionals.

Despite the sober outlook for total cluster employment and wages, the creative arts share of the cluster will continue to thrive. As labor markets tighten locally and nationally and wage growth firms, artists and performing arts companies will benefit from increased discretionary spending on arts and entertainment by visitors and residents alike.

Long-term outlook. The long-term outlook for Sonoma County's financial services, real estate and insurance industries is generally bright, but they will contribute less to total employment and wage growth than in prior expansions. Revised population data from the Census Bureau reveal that net in-migration decelerated substantially over the past four years, a period coinciding with significant deterioration in housing affordability. As the labor market tightens, better wage gains will begin to unleash pent-up demand for new single-family homes, and the continued influx of wealthy retirees will also support purchase demand. However, with house prices rising at nearly twice the rate of median incomes, in-migration and household formation will fall short of pre-

vious recoveries, limiting positive spillover into financial services, insurance and real estate.

Low business costs relative to San Francisco and plentiful access to venture capital will continue to favor Sonoma County as a global design hub, but a shortage of newly minted engineers will handicap efforts to retain and grow high-paying tech industries. As a result, the creative cluster's share of total employment will trail that of the Bay Area economies and the broader U.S.

Upside risks. Better than expected housing affordability would pay large dividends for Sonoma County's financial service and real estate industries by making homeownership more accessible for workers in the large hospitality, food manufacturing and agriculture industries. Recent efforts to increase affordable housing are a good start, and the relaxing of strict building codes in the county's unincorporated areas could increase the supply of lower-cost units.

Rising visits to Sonoma County lend upside potential to the creative arts. As consumer sentiment strengthens nationally and visitors to Sonoma County wineries extend their stays, local art galleries and performing arts companies stand to benefit. Though wineries, craft breweries and restaurants will remain the primary draw for tourists, visitors to wine country are seeking broader options for leisure. Efforts by local arts councils to integrate galleries and performing arts companies into the visitor experience could broaden local artists' exposure, fostering a virtuous cycle that attracts more high-income visitors.

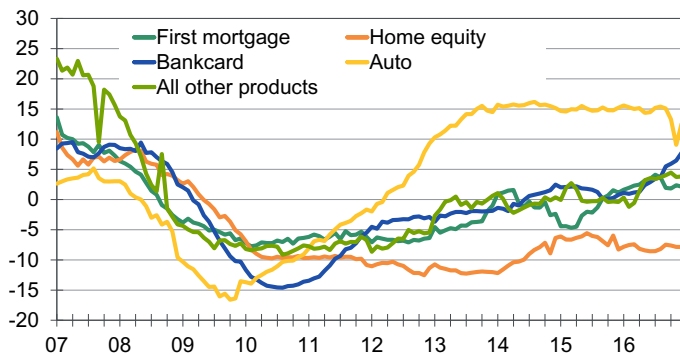
Downside risks. Restrictive trade and immigration policies advocated by the Trump administration would deal a larger setback to local tech firms given reliance on global supply chains and an international workforce. Action to deport undocumented immigrants would severely restrict labor supply in winemaking, hospitality and food manufacturing, putting local firms at a considerable cost disadvantage and disrupting local production.

If the Federal Reserve raises interest rates more quickly than expected, the resulting financial market volatility could hurt risk-taking at Sonoma County financial institutions and reduce capital available for business and consumer lending. If higher short-term interest rates prompt greater than expected capital inflows, a flatter yield curve would reduce financial institutions' net margin.

Jesse Rogers
February 2017

Consumer Lending Turns Corner...

Outstanding balances, % change yr ago, Sonoma County

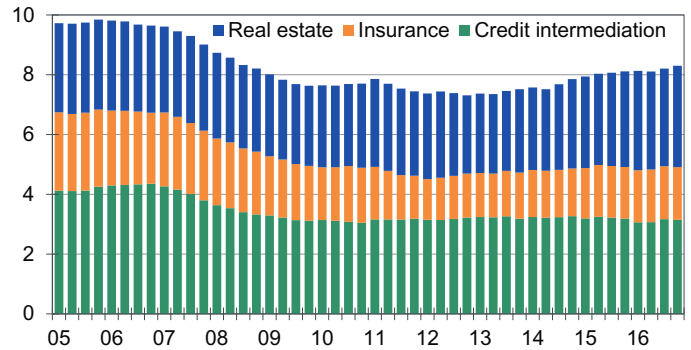


Sources: Equifax, Moody's Analytics

Despite the long reign of near-zero interest rates, Sonoma County's financial institutions have kept afloat by extending credit to the rapidly growing hospitality and food and beverage industries. Consumer lending has been slower to rebound, but robust personal income gains in recent years are driving demand for new auto, credit card and mortgage lending. Though mortgage credit remains tight for all but the most creditworthy borrowers, household balance sheets are in fine shape and will enable consumers to finance larger purchases, including new homes.

...Lifting Financial Sector Payrolls

Financial services employment, ths

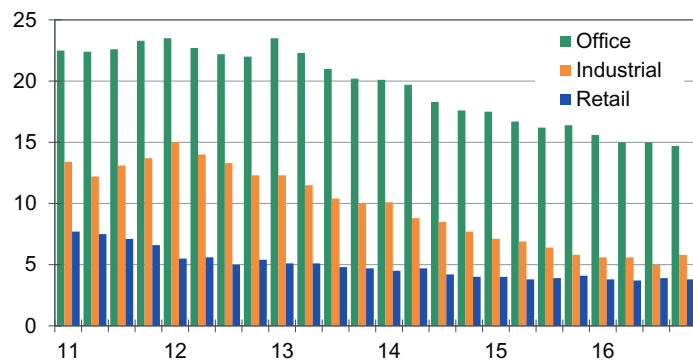


Sources: BLS, Moody's Analytics

Rising consumer and business lending has begun to lift employment in financial services, but the industry will not recover its former prominence at the height of the housing boom. Though better wage gains will drive demand for new mortgage lending, slower population growth will keep the upswing in home purchases and new residential construction well below prerecession peaks. The tight purchase market has already lifted real estate and insurance payrolls, and further gains will rest on credit intermediation, which has traditionally expanded at a more modest rate.

Low Vacancies Will Spark New Construction

Commercial vacancy rate, %

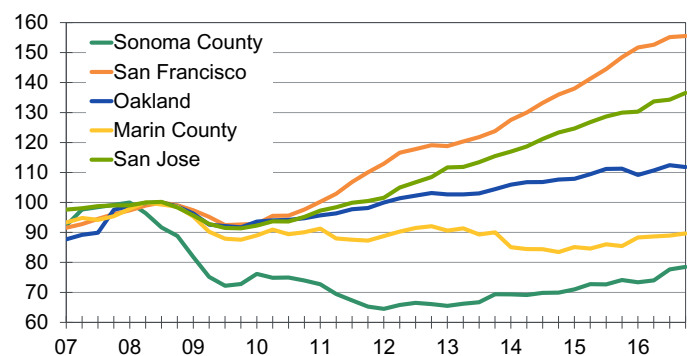


Sources: Keegan & Coppin Co., Moody's Analytics

Competition for space will intensify over the next year as county food and beverage makers and hospitality operators push forth with plans for expansion. Though there is sufficient office space to absorb new demand, the industrial and retail markets are approaching critical tightness. County food and beverage producers will break ground on several new facilities as they race to extend offerings to nationally based supermarkets. Further, efforts to refurbish downtown Santa Rosa are finally taking shape, and rising foot traffic will allow developers to fill new retail space.

Sonoma Creative Industries Slow to Recover

Creative industries employment, prerecession peak=100



Sources: BLS, Moody's Analytics

The creative cluster of industries has struggled to find its footing as the county's top tech employers downsize. Though Sonoma boasts one of the largest concentrations of creative arts employment in California and holds prospects as a global hub for apparel and graphic design, this part of the economy will grow only moderately over the next few years. Many tech employers retain a research presence in the county but will continue to shift research and development jobs to lower-cost centers in the U.S. and overseas, dimming prospects for growth.



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