



INDUSTRY INSIDER FINANCIAL, REAL ESTATE & CREATIVE INDUSTRIES

INDUSTRY REPORT

2018



ECONOMIC DEVELOPMENT BOARD

BOARD OF DIRECTORS

PAM CHANTER, CHAIR ▫ JORGE ALCAZAR ▫ SKIP BRAND
 TERRI DENTE ▫ TERRY GARRETT ▫ KATHRYN HECHT ▫ LINDA KACHIU
 WAYNE LEACH ▫ MICHAEL NICHOLLS ▫ MICHAEL TOMASINI
 BEN STONE, Executive Director

EDB FOUNDATION SPONSORS

FOUNDATION LEVEL



Luther BurbankSM
Savings

PRESENTING LEVEL



PREMIER LEVEL



EXECUTIVE LEVEL

- | | |
|-------------------------|--------------------------|
| ▫ AMERICAN RIVER BANK | ▫ SONOMA COUNTY ALLIANCE |
| ▫ COMCAST | ▫ SUMMIT STATE BANK |
| ▫ KEEGAN & COPPIN CO. | ▫ VANTREO INSURANCE |
| ▫ MIDSTATE CONSTRUCTION | ▫ WELLS FARGO |
| ▫ NORBAR | ▫ ZAINER RINEHART CLARKE |

MEDIA LEVEL



SONOMA COUNTY BOARD OF SUPERVISORS



CONTENTS

- 4. EXECUTIVE SUMMARY
- 6. FINANCIAL, REAL ESTATE & CREATIVE
INDUSTRIES: SONOMA COUNTY



EXECUTIVE SUMMARY

February 2018

The Sonoma County Economic Development Board (EDB), in partnership with the Sonoma County Workforce Investment Board (WIB), is pleased to present the 2018 Financial, Real Estate, and Creative Industries Industry Insiders report. Our research partner, Moody's Analytics, provided the research for this report. For additional information, questions, comments, or suggestions please contact us at (707) 565-7170 or visit www.sonomaedb.org.

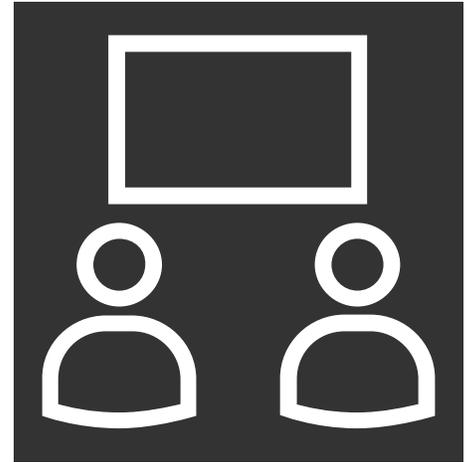
HIGHLIGHTS



The Federal Reserve will gradually increase interest rates, to the benefit of Sonoma County financial institutions. Higher short-term interest rates will not affect business in the county too significantly because consumers and businesses have already broadly adopted and locked in lower rates. Commercial lending in Sonoma County will be supported by expansion in Food & Beverage manufacturing, Restaurants & Hospitality businesses, and Health & Wellness centers. Consumer credit delinquency rates have now fallen to pre-recession levels across most loan products. Local community banks have recorded high levels of small loans, which should continue into the near-future.



In 2017, pre-fire single-family homebuilding and home prices hit record highs since the recession. As the Federal Reserve continues to increase interest rates, consumers will be driven to purchase homes sooner rather than later in Sonoma County; this purchasing power will be buoyed by recent income gains. But the lack of housing stock will soften expansion and growth and curb affordability; Sonoma County ranks among the top 15 least-affordable metro areas in the United States. A lack of commercial properties is forcing local businesses to seek creative ways to utilize small or unconventional spaces, or to expand beyond the county.



The Creative Economy occupations in product design and marketing will suffer as manufacturers face a shortage of large commercial properties on the market. These firms may respond by exporting their manufacturing to alternative locations while retaining their product design teams and marketers in Sonoma County. Or, they could respond by moving all operations outside the county. But for creative occupations in the arts and culture sectors, trends predict improved patronage. Tight labor markets will support wage growth, and the arts will benefit from increased recreational discretionary spending. Wage growth is also expected in the greater Bay Area, so visitor spending on the arts will similarly rise.



Recent Performance. Sonoma County is gradually returning to form after damages wrought by October wildfires. Total payroll employment paused briefly in October and November as tourists to wine country canceled visits, weighing on staff additions in mainstay consumer industries. However, these effects have begun to fade, and overall employment trends are improving. In the two months since October, more than two-thirds of private sector industries have increased payrolls, on par with the national average. While most coastal California areas are hurting for workers, the job market in Sonoma is especially taut: Not only is the jobless rate near a two-decade low, but the share of the working-age population with a job is at a new high. Labor shortages are evident in almost every industry, but are especially pronounced in construction.

The residential real estate market is also dogged by short supply. Labor shortages and scarce available land have kept homebuilders from meeting demand. The resulting squeeze on inventories has limited options for buyers and kept prices on the rise, straining affordability and contributing to a decline in the volume of home sales. The October wildfires exacerbated the supply-side crunch. Despite a jump in home sales in December and January, the median sales price—a key component of most measures of housing affordability—has surged to a new high.

Macro drivers. The U.S. expansion continues to power forward and fundamentals are strong. Real GDP growth remains just above 2% and job additions are advancing at more than 2 million per year. This is about the growth experienced since the expansion began more than eight years ago, and with deficit-financed tax cuts kicking in, growth should soon pick up further in the coming quarters. This pace is firmly above the economy's potential, and any underutilized resources are being absorbed quickly. Unemployment and underemployment rates are consistent with an economy operating beyond full employment. As a result, wage and price pressures are beginning to gain traction. While overall consumer price inflation remains subdued, the Federal Reserve will stick to its tightening campaign as wages rise and idle labor becomes scarcer.

Despite the positive near-term outlook, trade and immigration policies advanced by the Trump administration have the potential to slow growth. A trade war remains unlikely,

but should foreign countries retaliate against U.S. tariffs, pushing goods prices higher, consumer spending and overall economic expansion would dampen. Immigration policy is an additional source of uncertainty. If more undocumented workers are forced to leave the country, labor force gains would tail off and heighten labor constraints. Tighter immigration policies, including a proposed plan to limit new green cards, would further weigh on population growth, which is advancing at its slowest rate in decades.

Financial services. As inflation pressures build, the Fed will stay the course of monetary policy normalization. The Fed hiked the federal funds rate three times last year, and Moody's Analytics expects a 25-basis point rate hike per quarter and a steady decline in the central bank's balance sheet over the next two years. Sonoma County's financial institutions will fare better in a rising interest rate environment. The net interest margin—the difference between interest rates on borrowing and lending—will widen as the Fed hikes the federal funds rate, adding to banks' profits. Although higher short-term rates will raise the cost of capital, they pose little threat to the economy because businesses and consumers have already moved to lock in lower rates.

Rapidly increasing food and beverage manufacturing, as well as restaurants, wellness and hospitality will buoy commercial lending. Although business formation has trailed that in the state's larger metro areas, growth in new establishments has kept ahead of that of the U.S., generating demand for credit and capital and supporting local financial institutions. Santa Rosa-based Exchange Bank, the largest community bank in Sonoma County, reports strong earnings growth thanks in part to its small-business loan portfolio. Similarly, Summit State Bank, the second largest bank in the county by assets, reported robust fourth quarter gains in loans, although the bank finished the year in the red as it doubled its employee count to support new lending.

Consumers will likewise offer support. According to Equifax, outstanding balances for auto, bankcard, mortgage, and home equity credit have risen steadily since 2016 while delinquency rates fell below prerecession levels across most loan segments. The combination of rising balances and low delinquencies suggests consumers will be able to take on new debt without being

overstretched. Nevertheless, strength in the balance sheets of households and financial institutions will not translate into a large increase in industry employment given high business costs, outsourcing, and automation in depository credit intermediation. Furthermore, any jobs created will do little to raise local incomes, since average annual earnings in these positions are more than one-third below the state average.

Real estate. Sonoma County's housing market has turned considerably higher over the past two years. Single-family homebuilding made the most meaningful progress in 2017 since the recession hit. According to the Case-Shiller and FHFA indexes, house prices have surpassed their prerecession peak. Stronger income gains and rising interest rates will motivate more prospective homeowners to move quickly on purchasing a home, supporting sustained growth in housing demand.

The biggest hurdle for the housing market will be supply shortages. Tight residential inventories tied to limited land and labor have supported house price appreciation, but they have also kept many from purchasing a home: Affordability has declined steadily in the past five years. According to the Moody's Analytics Housing Affordability Index, which measures the share of median family income required to purchase a median-priced home, Sonoma County ranks among the top 15 least-affordable metro areas in the nation. The October wildfires have only heightened this concern. Affordable housing was in short supply before the blazes, and the destruction of more than 5,000 single-family homes—approximately 3% of the county's housing stock—will put additional upward pressure on house prices.

Fortunately, few commercial properties were lost in the wildfires, and the commercial real estate market remains healthy as developers add space at the fastest rate in nearly two decades. Robust demand and low vacancies are sustaining new construction as thriving tourism-centric businesses expand to absorb industrial, retail and office space.

Restaurants, food and beverage manufacturers, and hotels have been a considerable source of growth. Bear Republic opened a new brewpub in Rohnert Park last summer, and Russian River Brewing Co. is gearing up for the grand opening of a 90,000-square-foot facility in Windsor. New shopping centers such as the Deer Creek complex are also filling quickly, and the county is expected to have more than 600 new hotel rooms avail-

able to tourists this summer as developers rush to match soaring visitor counts.

Nevertheless, commercial inventories are exceedingly tight. With few options to pick from, some expanding businesses are getting creative; Greystone Hotels is converting an office building in downtown Santa Rosa into a boutique hotel. Meanwhile, a shortage of industrial space has been a particular obstacle for larger food and beverage manufacturers such as Amy's Kitchen, who have opted to expand beyond the county. The revival of downtown Healdsburg and Santa Rosa should make more room for new restaurants, hotels, and other hospitality establishments, but land constraints will make it more difficult for larger manufacturers to expand.

Insurance. Insurance markets are still roiling in the aftermath of the October wildfires, and with both repayment and rebuilding efforts expected to last at least a few more quarters, Sonoma County's insurers will take some time to recalibrate. According to the California Department of Insurance, the blazes were the costliest in state history, and at \$7.8 billion, Sonoma County incurred two-thirds of the direct losses. The lion's share of claims was for residential personal property, but commercial property and autos also suffered hundreds of millions of dollars in damages. In all, insurers have paid out about half of the total losses.

Sonoma County's homes and businesses are mostly covered by large, national insurers. Therefore, it is unlikely that local insurance offices will be devastated by payouts for fire damage. At the same time, more residents are demanding increased coverage as stories emerge of underinsured neighbors who lost their homes in the fires. According to CoreLogic, about 60% of American homes are underinsured by an average of about 20%, and in Sonoma County, where median property values are well above the national average, this can mean a loss to a homeowner of tens to hundreds of thousands of dollars. With more residents seeking to up their coverage and high chances of modest premium hikes this year, local insurers' near-term profitability will improve, offsetting some of the losses.

Nevertheless, the blazes left many insurers on edge, and some are refusing to issue renewals to residents near the affected areas. If insurers become more selective about which areas they will cover, Sonoma's residents will have no choice but to purchase less comprehensive property insurance from the

state through Fair Plan. Meanwhile, underinsured residents who lost their homes in the blazes will undoubtedly face steep, out-of-pocket rebuilding costs.

Crop insurers and vintners emerged from the fires largely unscathed. Almost 70% of Sonoma County's wine crops are insured and crop insurers are protected by federal subsidies. As prolonged dry conditions push more vintners to buy coverage, crop insurers will benefit from more monthly payments, but any potential losses will be minimized by federal support.

Creative cluster. Sonoma County will remain a hub for creative industries and entrepreneurship, but employment and income gains in these industries will be modest at best. Local biotech and IT firms have been slow to recover in comparison to the rest of the labor market, and while large employers such as Keysight Technologies and Medtronic will lend stability to the economy in the medium term, they will not contribute much to growth. Though the two firms retain a large research and development workforce in the county, they have gradually shifted manufacturing jobs to lower-cost centers in the U.S. and overseas while adding research staff elsewhere in the U.S. The globalization of local research operations could put additional jobs in peril as more emerging markets climb the value-added chain.

Despite the modest outlook for total cluster employment and wages, the creative arts will thrive. Tighter labor markets locally and nationally will support firmer wage growth, and artists and performing arts companies will benefit from increased discretionary spending on arts and entertainment by visitors and residents alike.

Long-term outlook. Sonoma County's financial services, real estate and insurance industries will fare well in the near term as the economy's strong fundamentals power through, but these industries will contribute less to total employment and wage growth than in prior expansions. Net in-migration has slowed substantially over the past three years, and deteriorating housing affordability has created barriers for migration to the area. A tighter labor market will power better wage gains and begin to unleash some of the pent-up demand for new single-family homes. However, with house prices rising at nearly twice the rate of median incomes, and wildfire rebuilding taking up some of the scarce available resources, in-migration and

household formation will fall short of previous recoveries, limiting positive spillover into financial services, insurance and real estate.

The long-term outlook for the creative cluster has turned more cautious. The combination of high business and living costs and a shortage of college graduates in STEM fields will pose a challenge to retaining and expanding high-paying tech services and design firms.

Upside risks. Policies to increase the supply of affordable housing could alleviate the county's housing shortage, which would lift in-migration and labor force growth in the near and medium term. The October wildfires present an opportunity to rebuild the county's housing stock and incentivize developers to increase the supply of rental and buyer properties available to lower-income residents. The relaxing of strict building codes in the county's unincorporated areas is a good start and could pave the way for more comprehensive efforts to increase the supply of affordable units.

Increasing visitor arrivals lend upside potential to the creative arts. As disposable incomes strengthen nationally and visitors to Sonoma County wineries extend their stays, local art galleries and performing arts companies could see more positive spillovers as visitors to wine country are seeking broader options for leisure.

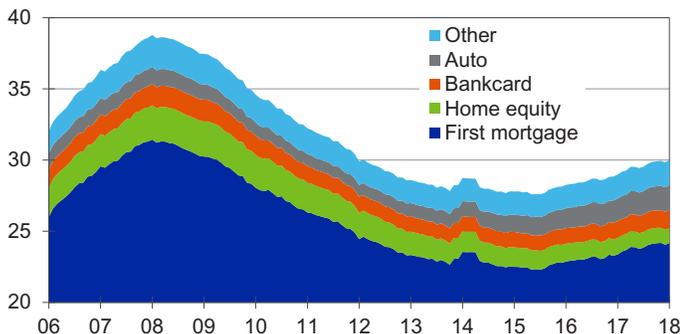
Downside risks. Tighter immigration and protectionist trade policies are a considerable risk to Sonoma's leading industries given the extremely tight labor market and local firms' reliance on export markets. The blow to wineries, breweries, hospitality operators, and tech firms would ripple through the local finance, insurance, and real estate industries, pushing up costs and reducing demand.

Climate change is a growing risk, not only to the insurance industry, but also to residents and real estate markets. The October wildfires demonstrated the havoc a natural disaster can wreak on Sonoma's insurers, and should they become increasingly risk adverse and deny coverage to parts of the county, this could create more problems for homeowners and discourage in-migration to the area. Fortunately, vintners are well-covered if disaster should hit, but longer-term changes in climate patterns, particularly increased instances of dry spells, could hurt crop quality and profitability and drain the resources of local insurers.

Maria Cosma
February 2018

Consumer Lending Is on the Rise...

Sonoma County total outstanding balance, \$ bil

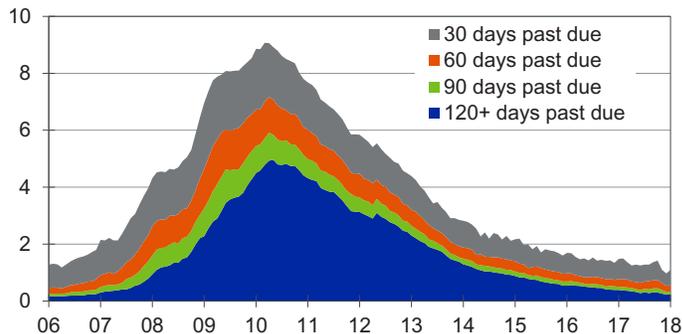


Sources: Equifax, Moody's Analytics

After declining for much of the recovery, consumer lending in Sonoma County has been on the upswing for the past two years, supporting local financial services. Consumers still have plenty of capacity to borrow and easing lending standards, particularly in bankcard and new mortgage loans, will support more lending. That said, new mortgage lending will advance more modestly as diminished net migration weighs on housing demand. Still, with interest rates on the rise, local banks will enjoy a higher net interest margin and thus greater profitability.

...But Balance Sheets Remain Pristine

Sonoma County delinquency rates, % of outstanding \$

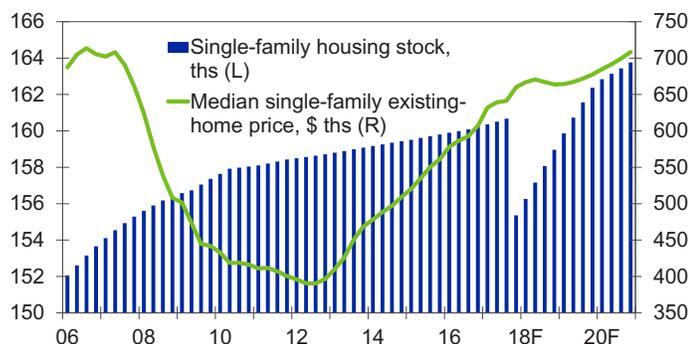


Sources: Equifax, Moody's Analytics

Sonoma County's residents are flourishing under stronger wage and income growth, but robust consumer sentiment and a wherewithal to spend has not yet translated into risky lending. Household credit quality is strong, and delinquency rates in all categories are falling. All loan categories are fast approaching or have already dipped beneath their prerecession lows, suggesting that consumers will be able to take on more debt with ease. Pristine balance sheets bode well for financial services, which will continue to lend in the more favorable interest rate environment.

Wildfires Leave Their Mark

Sonoma County

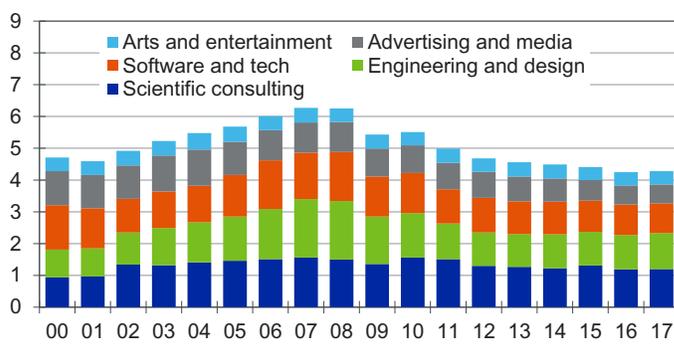


Sources: Census Bureau, California Assn. of Realtors, Moody's Analytics

The October wildfires destroyed a significant portion of Sonoma County's single-family housing stock, putting more pressure on already-tight inventories. At the current permitting pace, rebuilding will take at least two years, and rising construction costs tied to labor shortages will exert stronger upward pressure on house prices. Declining affordability and fewer available homes for sale will discourage prospective homebuyers from making a purchase in the area, weighing on migration into the county and thus suppressing housing demand.

Creative Industries Past Their Heyday

Sonoma County, % of total employment



Sources: BLS, Moody's Analytics

Creative industries will remain a part of Sonoma County's economy but will contribute only modestly to job and employment growth over the next few years. High-tech service industries such as software development and informatics, 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. Though arts and entertainment are only a small share of the creative cluster, greater visitor spending on them will be a benefit.



SONOMA**EDB**.ORG

707 - 565 - 7170

141 STONY CIRCLE, STE. 110, SANTA ROSA, CA 95401