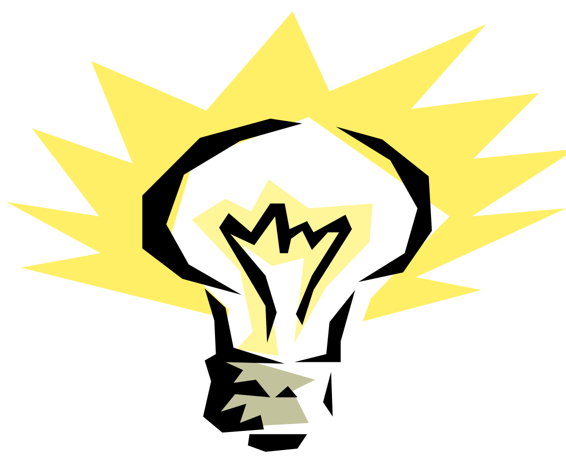
# Sonoma County
# Economic Development Board

**presents**

# Financial Services
# and the
# Creative Cluster



## 2003

Prepared By

THE SONOMA COUNTY ECONOMIC DEVELOPMENT BOARD

Ben Stone, Director

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The Sonoma County Economic Development Board is pleased to bring you our annual report on financial services and the creative cluster.

The creative cluster in Sonoma County helps bring innovation and new ideas that drive technological advances and higher wages.

In addition you will find important information regarding current trends in local finance, insurance, and real estate markets.

Highlights from the *2003 Financial Services and Creative Clusters Report* include:

- Low interest rates are driving demand in financial and real estate markets.
- Non-residential real estate market remains troubled despite slight improvement.
- Banks are doing remarkable well in comparison to the rest of the economy.
- Insurance companies are doing much better thanks to higher premiums.
- Current economic conditions place downward pressure on the creative cluster.

This report is compiled for the Sonoma County Economic Development Board by Economy.com.

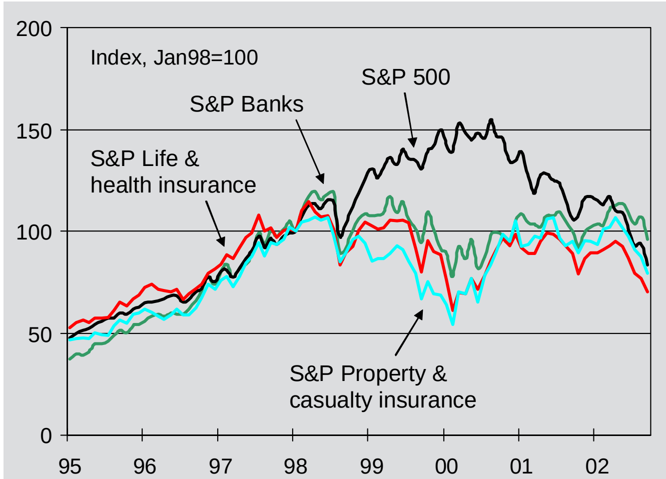
Thank you again for your interest in Sonoma County's economy and the Economic Development Board's research efforts.  As always, if you have any questions please feel free to contact us at 707-565-7170.

Sincerely,

Ben Stone
Director

# Sonoma County: Financial Services and Creative Cluster

**Financial Services: Recent Trends.** Sonoma County's financial services industry continues to perform well, resulting in payroll increases over the past year. This contrasts with a payroll decline seen in the industry in the rest of the Bay Area. The industry's growth is constrained, however, by the weak local economy. Sonoma County remains in recession with few signs of improvement save a leveling off of the jobless rate near 5%. All major components of the economy—winemaking, technology and tourism—are suffering simultaneously. Local banks, as elsewhere in the U.S., have benefited from beneficial interest rate spreads that have bolstered overall returns. Low interest rates have also caused the industry to expand in response to strong demand for loan refinancing. This trend, however, has passed its peak.




The performance of real estate markets is mixed. House-price appreciation is soaring due to low interest rates, but the number of sales and new construction permits eased during the first half of this year. The nonresidential market remains troubled, although there is some improvement in office markets, where the vacancy rate fell to 16.3% in this year's second quarter from a high of 19.1%, according to Keegan & Coppin Co., Inc. Industrial vacancies have remained steady near 10% over the past year.

**Macro Drivers.** The U.S. economy is fragile, but firming. However, a more broad-based and sustained rebound in demand is necessary for manufacturers to meaningfully curtail their job cutting. Currently, demand is receiving a boost from lower interest rates. Although interest rates have backed up since their June nadir, fixed mortgage rates are still near 6%. The housing and mortgage refinancing markets remain strong, each posting new record levels of activity this summer.

On the corporate side, businesses are largely taking advantage of lower rates to reduce borrowing costs rather than invest in capital equipment, such as IT goods. Consequently, high-tech manufacturers are still struggling with excess capacity that weighs on prices and harms profitability. Many tech manufacturers still are posting losses and cutting costs and payrolls, including local firms, such as Agilent Technologies, Nokia, and Advanced Fibre Communications. During the current sluggish economic environment, increasing bank assets is difficult. Federal Reserve surveys suggest that businesses' reluctance to borrow is the primary reason for the weak loan growth rather than bank reluctance to lend, a credible conclusion given the improvement in corporate balance sheets. The key to a rebound in corporate borrowing is confidence.

**Financial Services.** Commercial banks remain in very good shape, a standout industry in an otherwise sluggish economy. While low interest rates and overall soft loan growth are still causing interest income to decline, profitability remains very strong as net interest margins, interest charged less the cost of funds, remain very wide. Accordingly, bank returns on equity and assets are at historic highs. Nationally, commercial banks' return on assets remains close to a historically strong 140 basis points, according to the FDIC. Wide net interest margins and restrained costs have supported profitability. The banking system's very strong capital position is also buoying profits. Banks have benefited from the ability to maintain generally favorable net interest margins despite softer demand for credit.

Profits for the 11 banks headquartered in the tri-county North coast region increased 20% in 2002 from the previous year, and the profitability remains strong this year as well. The industry's long-term growth prospects are quite favorable, given the presence of strong long-term growth drivers, such as high-tech telecom and optical equipment manufacturing, wines and other food products, and tourism. A fourth driver, retail trade, is also significant, not only as part of the local tourism industry, but also as a regional trade center for the north coast region.

Specialty mortgage lenders, such as WAMU's North American Mortgage Company, are expanding. Purchase, refinance and home equity lending all continue to surge at the expense of credit card and other consumer credit lenders. Moreover, while credit quality has deteriorated, mortgage delinquencies remain below previous peaks, and solid house price gains have limited losses. Risks are mounting for these lenders, but given that interest rates are expected to remain low for longer than originally expected, the near term looks generally positive.

**Real Estate.** Given the weak condition of local manufacturing, demand for industrial space will remain tepid until a revival of business capital spending helps local high-tech firms to expand product lines, inventory and research & development. At least as builders have responded to moderating demand, future increases in the supply of space will be limited, helping generate a potential rebound in rents sooner. Similarly, the decline in business services employment is crimping demand for office space. Local business capital spending, including spending on new structures, will remain subdued through next year, rather than rebounding over the latter half of this year as had been projected earlier.

As major creditors to commercial real estate interests, local banks as well as landlords are fortunate that vacancy rates have improved in recent months. Office vacancies have fallen for two consecutive quarters through mid-year 2003 and the industrial vacancy rate, while volatile, is down from last year's peak. Both rates are below U.S. averages as reported by CB Richard Ellis. Consequently, rental prices for office and industrial space are holding steady, in contrast to still-falling rates elsewhere in the Bay Area.

Overall expenses for landlords have remained fairly stable over the past year. Landlords have taken advantage of low interest rates to refinance debt, which is helping to provide a cushion for diminished rental income. Although post-9/11 security costs for personnel and equipment have risen, the soft labor market has helped landlords contain labor costs for security as well as other services.

**Insurance.** High premiums are helping property and casualty insurers and insurance brokers alike. Property and casualty insurers' overall financial performance improved markedly during the first quarter of 2003, which suggests a significant improvement in the fortunes of State Farm. A combination of rate hikes over the past three years and the increases in reserves taken during the fourth quarter helped the industry achieve a statutory rate of return of 8.8%, compared to 1% in the first quarter of 2002. Rates for commercial lines remain high, but the fast pace of premium growth has tapered off since the third quarter. Premium growth in personal lines has moderated recently, after strong growth between late 2002 and spring.

The industry's usual procyclical performance has become detached from broader economic trends since the 9/11 terrorist attacks. Although substantial write-offs for patching up balance sheets resulted in disappointing year-end results for 2002, improved financial performance and nearly three years of strong premium growth helped property and casualty insurers record solid financial results and end underwriting losses during the first quarter of this year. However, optimism about the industry's prospects remains subdued because of long-standing structural problems, such losses stemming from many years of poor underwriting standards.

As the nation's leading mutual home and auto insurer, State Farm's retreat from an aggressive pricing strategy has improved the company's financial performance and contributed to long overdue increases in premiums. The company's improved performance will not lead to new hiring, but it will reduce the likelihood of further major cutbacks, which have included closures of facilities statewide and job cuts at its local processing office. State Farm recorded net losses of almost $3 billion in 2002 and $5 billion in 2001.

The sluggish economy and rising litigation are driving unfavorable results in workers' compensation lines, which incur a higher frequency of claims during periods of rising unemployment. Private workers' compensation is increasingly being issued by the State Compensation Insurance Fund, set up initially as the insurer of last resort. Locally, the Fund office added workers last year as a result of its increasing business produced by the lack of availability of private coverage.

**Creative Cluster: Definition.** The creative cluster is a group of industries that, at their core, employ persons in the fields of science and engineering, architecture and design, education, arts, and music and entertainment who create new ideas, new technology or new creative content. This core cluster also is associated with creative professionals in business and finance, law, healthcare, sales management and related fields to form the County's creative cluster of occupations.[1]

Sonoma County's creative cluster is disbursed quite broadly across its basic industries. The progress of its vineyards and winemaking industries is dependent upon scientific research, as are the County's telecom and optical instruments industries. Linked closely are the legal, finance and marketing firms that protect their intellectual property, finance their research and expansion, and develop their markets. The arts, design and entertainment occupations are key components of the County's tourism industry. Education and healthcare round out the creative cluster.

**Recent Performance.** The creative cluster was crucial to the County's economic growth during the late 1990s and into 2000, and it continued to expand in 2001 as well. While occupation data that track the cluster are not yet available for 2002, the cluster is assumed to have shrunk after the 2001 recession and specific industry conditions pummeled demand for its three basic industries—wine, tech products, and tourism—causing payrolls in each to decline. This decline has not yet ended.

The creative cluster accounts for approximately 29% of the County's employment, about equal to the national average. Thus, the economy does not have an outsized presence of the creative cluster. Yet, what is important is that each of the County's three basic industries relies on the creative cluster of workers to generate new or improved products for long-term growth. In other words, none of the three industries produces basic commodities. Each is rather specialized in its field and is generally oriented toward the high end of its specific market.

Current economic conditions place difficult downward pressure on the creative cluster at the moment, yet it is the creative cluster that will help the economy to rebound from its downturn. The current difficulty comes from the fact that the creative cluster often relies on investment spending to support research or product development, whether it be in the arts, sciences or business. Yet investment spending generally is rebounding at only a moderate pace.

One positive factor, however, is the generally good financial condition of Sonoma County financial intermediaries. Another positive factor is that venture capital placements in the greater Bay Area rose in the second quarter, indicating the long downturn in investing in startup firms may be over. Thus, there is reason to believe that workers in the creative cluster, whether they are directly associated with existing firms or are working independently or with new ventures, will find a more supportive working environment in the months and years to come.

Furthermore, the County's ability to retain and attract workers in creative occupations is supported by a number of strengths, including a pleasing environment and good quality of life factors that reflect low population density, amenities such as beaches, rural environs, favorable climate, good schools, and its proximity to major commerce and cultural attractions of the Bay Area.

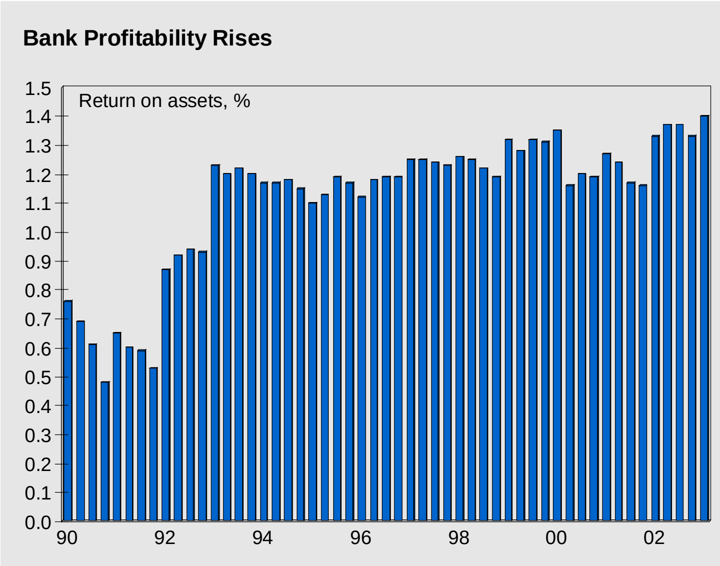
**Long-Term Outlook.** The financial services industry in Sonoma County continues to have a positive long-term outlook. Favorable interest rate spreads should support the industry until the local economy's driving industries turn the corner in 2004 and 2005. The housing market remains healthy and rather balanced between supply and demand. Office and industrial real estate markets should improve longer term, but will need 12 to 18 months to absorb excess supply. The County's creative cluster will be an increasingly important driver of the economy in generating long-term comparative advantage for the area's basic industries.

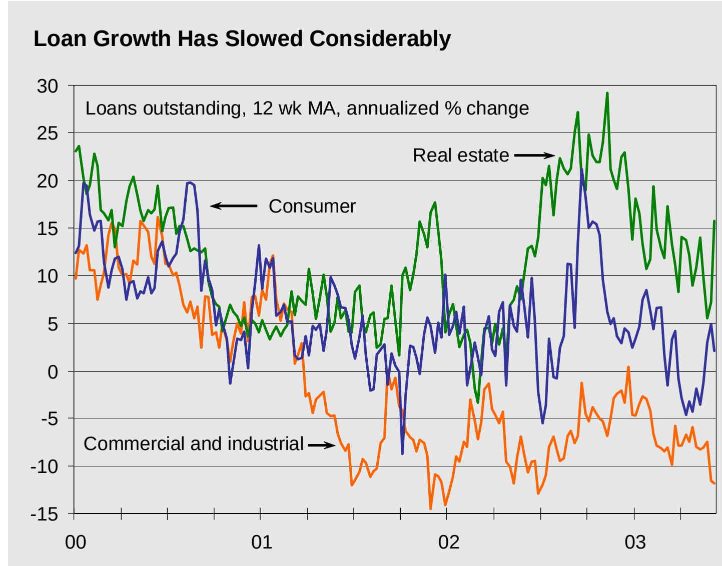
**Upside Risks.** A stronger than expected rebound in business investment will help lift depressed sales of local high-tech telecom and optical equipment manufacturers. Such a turnaround would generate new opportunities for local investment as well as improve local credit conditions by reducing unemployment, boosting incomes, and accelerating the pace of home price appreciation.

**Downside Risks.** While personal bankruptcy filings remain stable, business filings continue to rise, generating some risk that defaults on commercial and industrial loans could rise before economic conditions improve. Similarly, rising business filings could lead to further job cuts, causing household credit quality to deteriorate as well. Over the long term, problems with housing affordability and lack of venture capital could cause creative class workers to seek more inviting locations, thus limiting the generation of new ideas, products and, ultimately, new industries that help the economy to flourish.

*Steven G. Cochrane*
*September 2003*

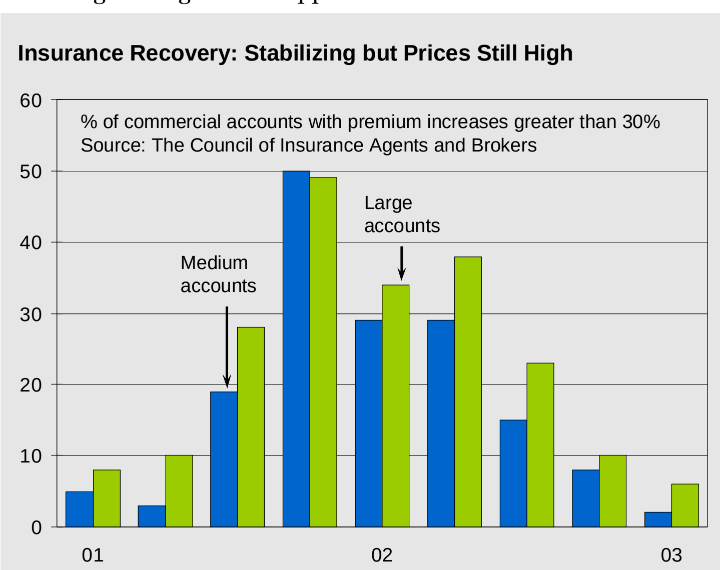
[1] Florida, Richard (2002), *The Rise of the Creative Class*, Basic Books, p. 8.

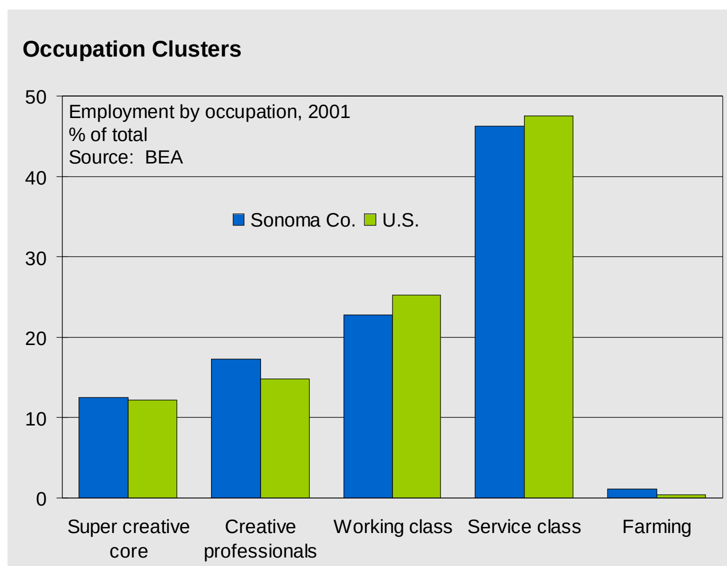



The surge in nonresidential construction permits starting in late 2002 has come to an end during recent months just as residential activity is picking up after four years of decline. The rise in nonresidential permits was driven largely by office permits, which have collapsed this year. University construction projects probably account for the bulk of late 2002 office permitting activity. Low nonresidential activity is good for landlords given high office vacancy rates, particularly those in the North Corridor where vacancy rates have skyrocketed to 20.8% in Q1 2003 from 13.9% at year-end 2001 according to Keegan and Coppin.

Bank profits are exceptionally strong. Industry return on assets was a record 1.4% in the first quarter of 2003, on the back of year-over-year net income growth of 15%. The strong bank performance is the result of wide net interest margins, not only on loans, but also on securities held. Also contributing to profitability is surging mortgage origination activity. Economy.com forecasts 3.3% growth in the value of mortgage purchase originations in 2003, to more than $1 trillion, easily a new record.




Bank loan growth is still very slow. Indeed, outside of home mortgages, loans outstanding are barely growing. Non-mortgage household loans are starting to pick back up, however, and will increase much more quickly once interest rates rise. Commercial loans look very weak now, but should quickly turn around once business investment in inventories and equipment grows more strongly, as expected in the second half of the year.

Premium increases that sharply accelerated after 9/11 are finally beginning to slow, but this is hardly the end of the hard underwriting cycle. In the first quarter of this year, roughly two-thirds of small, medium, and large accounts still faced rate increases of up to 20% for all lines of insurance. Prices moderated most in the commercial property and business interruption lines, while medical malpractice rates saw the largest increases. Rates hikes have slowed considerably from just after 9/11, when nearly one-half of large and medium accounts faced rate hikes of 30% or more.