

2005 Sonoma County Financial, Real Estate, and Creative Services Report



Prepared by the Economic Development Board
in Partnership with the Sonoma County
Workforce Investment Board

October 2005

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The Sonoma County Economic Development Board, in partnership with the Workforce Investment Board, is pleased to bring you the 2005 Financial, Real Estate & Creative Services Report. In this report you will find the latest available economic data and industry trends for these sectors in Sonoma County.

Key highlights of the trends that can be found in this report include:

- The prospects for the financial services industry remain solid. Sonoma County leads the state with particularly low bankruptcies, credit card delinquencies and loan delinquencies, so the County is particularly well insulated from the risks of increased interest rates.
- Employment in the construction industry has moderated in the past few months, but nonresidential construction projects have kept construction activity going in Sonoma County. There are plans to develop as much as 1.4 million sf. of new retail space over the next few years.
- The insurance industry has done very well over the past few years, but increased competition and more difficult conditions on the demand side make increased consolidations likely.
- Sonoma County's good quality of life factors will encourage continued development of Sonoma County's creative cluster, which will be an increasingly important driver of the economy.

I would also like to take this opportunity to inform you that an update to the County wide economic strategic plan is currently underway. This study will explore the increasing importance of the creative sector, as well as recommend policies which would strengthen Sonoma County's advantages in this sector.

As always, please feel free to contact the EDB Offices at (707) 565-7170, or by email at edb@sonoma-county.org. Please note the following list of underwriters whose generous support make this research information possible. Thank you again for your interest in the Sonoma County economy.

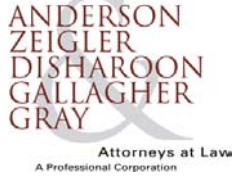
Yours sincerely,



Ben Stone



**With Acknowledgment and Appreciation to the Underwriters of the
Economic Development Board Foundation Research Initiatives Program**
 Sonoma County Permit & Resources Management Dept. ■ Sonoma County Office of Education
 Community Development Commission ■ Sonoma County Health Services ■ Codding Foundation
 Sonoma County Transportation & Public Works ■ Sonoma County Workforce Investment Board



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Recent Trends. While the Sonoma County economy is expanding moderately, employment in the financial services industry continues to shrink. Most of the job losses have been concentrated among the area's insurance carriers, while banks and other financial institutions are holding steady.

With residential construction permitting down over the year, the construction industry has moderated in the past few months. Employment in the industry is now about flat from the beginning of the year. Nonresidential projects have kept construction activity going in Sonoma County. Fortunately, nonresidential construction is less susceptible to higher interest rates, which offsets risk to the construction industry over the coming year.

Macro Drivers. Strong economic growth leading to record corporate profits coupled with well-controlled inflation are nearly ideal conditions for the national banking industry. Greater corporate credit demand will be an important and very favorable development in the coming year. Stellar profit growth and a focus on improving balance sheets have held back credit demand, even as business investment has grown at a steady pace over the past two years. Until recently internal funds were sufficient to finance most business investment. More recently, however, a sustained pace of mergers and acquisitions has added to financing needs, as has expansion among smaller firms.

With the economy's potential growth estimated by Economy.com to be 3.25%, what slack that remains in the job market and the rest of the economy is being steadily absorbed. This implies that inflationary pressures will intensify early next year and interest rates will rise.

An important development for the remainder of this year and next will be the rise in long-term interest rates. The Fed has raised the funds rate by more than 200 basis points over the past year, but several factors have conspired to allow long-term interest to remain low. This situation will reverse as soon as inflationary pressures build. Economy.com expects the Fed to continue with rate hikes, despite the uncertainty created by the impacts of Hurricane Katrina, elevating the funds rate to 4.0% by the end of 2005. Long-term rates will respond to expected inflation by rising late this year and into early next year.

Financial Services. The banking industry has carried the momentum of last year's record profit levels into 2005, with

many of the larger banks reporting all-time highs in profitability in the first half. Elevated mortgage activity and increased corporate borrowing have both persisted into the second quarter.

Nevertheless, the banking industry's environment will become more difficult in a number of ways. First, the Fed continues to tighten monetary policy, with at least two more rounds of increases in short-term rates expected before the end of the year; long-term rates are expected to rise also but the yield curve will flatten.

Rising long-term interest rates pose several problems for banks. First, there will be significant loss of income as carry trades become less profitable. Second, rising long-term interest rates will reduce profits in the lucrative residential mortgage market. Volumes and fees are set to decline and mortgage credit quality could deteriorate. Third, rising interest rates may engender some deterioration in corporate credit quality, especially if combined with stubbornly high energy prices.

Even with these challenges, however, near-term prospects for the industry remain solid. Businesses are borrowing again and so far have shown a preference for short-term borrowing through lines of credit with banks, as opposed to new bond issues. In California, personal credit conditions remain quite strong, even as national bankruptcy rates are approaching record highs. Sonoma County, in particular, leads the state with extremely low bankruptcies, credit card delinquencies, and loan delinquencies. This is due in large part to skyrocketing house prices, which have generated equity gains for homeowners. Although higher interest rates could lead to a correction in Sonoma County's labor market, it is unlikely that they could seriously impact the area's superior credit quality, which bodes well for Sonoma County's banks.

The outlook for hiring in the industry looks weak locally, despite strong revenue growth, largely due to consolidation and improved efficiency in operations. The buyout of National Bank of Redwoods by Westamerica led to a loss of more than 100 positions locally. Exchange Bank has also cut jobs locally, albeit through attrition rather than layoffs, and expects to post continued revenue growth with no hiring planned.

Real Estate. Median existing house prices are growing at a double digit pace in Sonoma County, as the Bay Area continues

to see some of the most robust price growth in the country. The market for vacation and investment homes seems to be going strong, pushing prices far beyond the level of affordability for the metro area's population. Anecdotal evidence suggests that roughly 20% to 30% of houses currently are sold as second homes to a wide assortment of both domestic and foreign buyers. Houses in the Bay Area are among the most expensive in the state, and Sonoma County now has the second highest median house price in that area. Permit issuance in the county soared in the second quarter of 2005, led by a sharp rise in multi-family permits, although it has since moderated.

The metro area's housing boom is out of step with market fundamentals, however, and remains vulnerable to an adjustment in house price expectations. Mortgage rates are expected to rise over the course of this year and next, lessening the demand for borrowing and slowing house price appreciation, which has been the source of a significant amount of consumer borrowing in recent years. Economy.com currently expects a gradual moderation in house price growth over the next year in Sonoma County, which will result in falling demand for mortgage financing and home sales. This will, in turn, take some steam out of hiring in the real estate industry locally.

Commercial real estate has been on a roller coaster ride. Layoffs among telecom and other office-using employment during the area's recession left landlords with a glut of available space. Although the market had been firming, office vacancy rates shot back up after the large Agilent campus became available. The company has ceased operations at its Rohnert Park campus and has outsourced the facility's manufacturing functions to Malaysia, resulting in a 60% reduction in its local workforce since 2001. The firm continues to downsize in Sonoma County, evidenced by a recent 300-person lay-off announcement. Sonoma's second leading telecom equipment manufacturer, JDS Uniphase, also continues to struggle and plans to cut 850 jobs this year, 350 of which will come from its Santa Rosa facility.

Agilent still has 1,900 employees in Sonoma County, and with the gradual recovery of the telecom sector, Agilent's outlook is improving. The company announced its fourth consecutive profitable quarter marking an important landmark for the company. The office vacancy rate now stands at 20.1%,

according to Keegan & Coppin. Meanwhile, medical manufacturer TriVascular announced its plans in August to lease a former Agilent building in the Airport Business Center. The 110,000 sf. lease is the largest since the tech boom in 2000 and will help to firm up Sonoma County's office vacancy rates.

Vacancy rates for industrial space have fallen from last year, but still stand close to 8%. The market for retail space has been much tighter, as vacancy rates have remained below 5% for the past four years, according to Keegan & Coppin, and rents have risen by as much as 80% over that period. There are plans to develop as much as 1.4 million sf. of new retail space over the next few years.

Insurance. The insurance industry has done very well over the past few years, but conditions are getting more difficult. Competition continues to intensify and returns on investments are low. More difficult conditions on the demand side suggest further consolidation in the offing; merger and acquisition activity in the industry has picked up since 2004.

Nationally, increasing competition is eroding pricing power, and growth in premiums is set to decelerate considerably in 2005. Although Sonoma County has felt little of this competitive pressure so far, it soon will. More than a dozen new insurers are entering the market in California. Recent troubles for private insurers have fueled the growth of the state-controlled State Compensation Insurance Fund, which has doubled its historical market share to a large 51%.

Since statewide workers' compensation reform in 2003 imposed various measures, including imposing limits on workers' benefits and reducing eligibility, claims and base rates for workers' compensation insurance are moderating. However, while claims by employers for work-related injuries have fallen by 36%, insurers' base rates have only declined by 27%. Employers are striving to gain a bigger share of the savings, which could put downside pressure on premiums.

Higher interest rates also have negative implications for the insurance industry. Mortgage applications for purchase have hit record highs in recent months, driving demand for home insurance lines. Rising home values and home improvements funded through refinancing are supporting gains in premiums.

Locally, State Farm boosted its presence in Sonoma County when it consolidated

four of its state facilities into two and transferred several operations to its Sonoma County center. Following the consolidation, however, efficiency gains have led the firm to pare back on local employees.

Creative Cluster. The creative cluster is a group of industries that, at their core, employ persons in the fields of science and engineering, architecture and design, management and finance, education, arts, music and entertainment who create new ideas, new technology or new creative content. In Sonoma County, these occupations employ roughly 30% of the local workforce, approximately two percentage points above the national share. While slowing dramatically from their peak in 2000, these occupations have weathered the local downturn fairly well; in 2002, for example, the creative cluster grew moderately while total employment declined.

Creative industries represent a significant portion of the local industrial base. Several major tech segments, including telecom and navigational/electromedical equipment, utilize the creative cluster of workers to generate new or improved products for long-term growth. These are industries, despite travails of the past several years, with growth potential for employment with above average wages and salaries, and they can be used to lure further high-tech investment to the county. Other drivers of the local economy, including wine and tourism, also rely on creative clusters to thrive.

In the near term, creative cluster employment growth will lag that of other industries. Creative clusters often depend on investment spending and venture capital to support research and fuel product development. While venture capital flows have improved, the major destination for funding in the Bay Area has been biotech, an industry with a relatively small but growing presence in Sonoma County. Medtronic is by far the largest biotech firm in Sonoma County, but there are several smaller companies that are drawn to the North Bay area by its large share of professionals with technical, scientific, or biomedical backgrounds. Sonoma County will continue to attract the biotech industry, which will be an important asset to the area over the long run. Once current lagging venture capital investment returns to traditional drivers, including electronics and software, creative employment should experience a marked improvement.

Long-Term Outlook. Despite recent troubles among insurance carriers, the financial services industry in Sonoma County has a positive long-term outlook. Interest rate hikes may cause some short-term fluctuations, but Sonoma County has many comparative advantages to attract more financial services business, including above average per capita income, good quality of life factors, favorable climate, and proximity to San Francisco. These factors will also encourage development in Sonoma's creative cluster, which will be an increasingly important driver of the economy in generating long-term comparative advantage for the area's basic industries.

Upside Risks. Sonoma County benefits greatly from spillover growth in other sections of the Bay Area. Should San Francisco, Oakland, and San Jose rebound more quickly than anticipated, Sonoma County should see an influx of financial services, real estate, and creative employment. Additionally, as home to several high-tech manufacturers, the area could see an increase in federal funding as the government looks to bolster its systems and electronic intelligence capabilities. Finally, further acceleration of business investment will help both Sonoma County's financial institutions and its high-tech equipment manufacturers.

Downside Risks. 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.

Furthermore, should interest rates rise faster or higher than expected, it would have a particularly potent effect on Sonoma County's housing market. While our baseline forecast does not call for a fall in house prices, an unexpected surge in interest rates could very well drive all speculative pressures from the market and cause a moderate price decline.

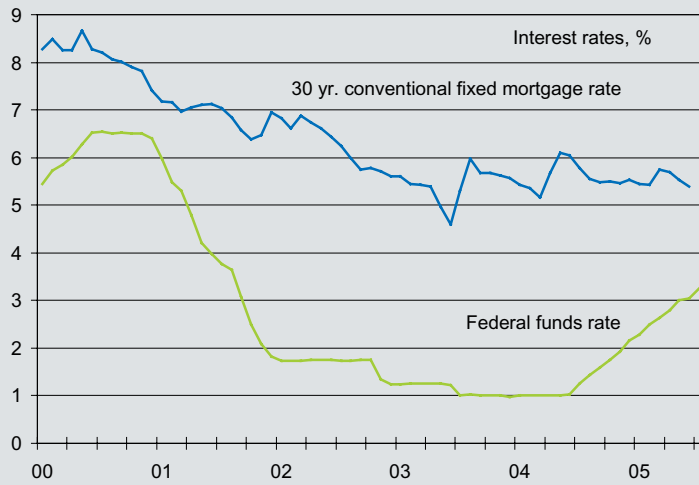
Further, energy prices continue to present a major downside risk. Oil prices have hovered above \$60 per barrel through August, and the aftermath of Hurricane Katrina is also expected to retain upward pressure on energy prices for the next few months. This level of uncertainty can lead to delays in business investment decisions, which could prevent a fuller recovery in business borrowing that has slowly been building.

Sean Maher

September 2005

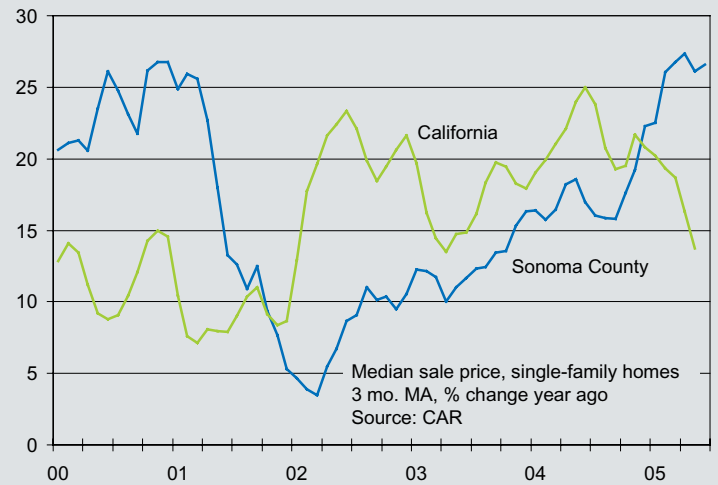
Financial, Real Estate and Creative Industries – Sonoma County

Mortgage Rates Stay Low Despite Fed's Rate Hikes



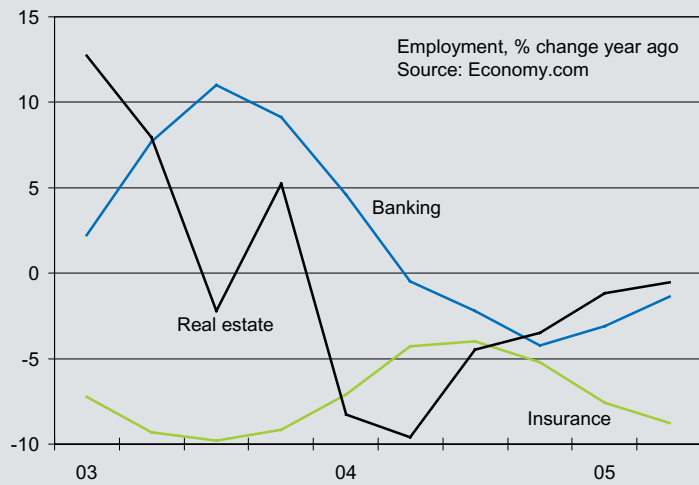
Mortgage rates have remained incredibly low despite the Fed's persistent ratcheting up of interest rates. Mortgage lenders have followed the lead of other long-term funds, which have also kept rates very low. Several reasons have been cited for this unprecedented behavior of long-term interest rates. Fundamental ones include elevated Fed credibility and explicit guidance from the FOMC on the path of near-term interest rates, both of which have depressed risk premiums in bond yields. Technical explanations include Asian central bank buying of U.S. Treasury securities and the "carry" trade—when investors borrow at low short-term rates to purchase long-term bonds.

House Price in Sonoma Show No Sign of Slowing Down



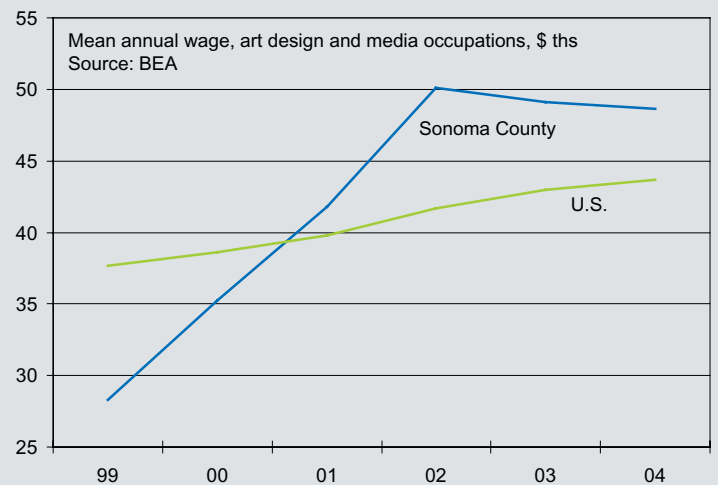
Repeating a trend that last ended in 2001, house-price appreciation in Sonoma County is soaring well ahead of the statewide average. Stronger income growth, moderate job gains and persistently low interest rates are fueling the local market. Affordability has deteriorated and residential construction activity has not accelerated to meet demand; indeed, total residential permits in 2004 were down by 14% from 2003. Permit issuance accelerated some in the first half of 2005, but has moderated again since. There is some upside potential arising from a new internet-based permit application process in the area that may expedite construction activity.

A Weak Jobs Recovery



Although most companies in the financial services and real estate industries are currently posting solid profits, they remain unwilling to increase payrolls. This is evident in Sonoma County as well, where total payroll growth remains weak, and payrolls in most finance industries continue to shrink. Consolidations in banking have helped the industry exact savings from cost cutting and layoffs. Meanwhile, most companies have made use of the recent recession to revisit operational efficiencies, leading to increased offshoring of back-office operations and investment in labor saving technologies. As a result, the outlook for employment gains in the industry remains weak.

The Creative Classes Are Top Earners



The value of the creative classes to a local economy has been documented in studies. Although typically a smaller cohort by size of the local economy, the creative classes are generally better paid than average, which helps boost their spending power. Further, some of these design and creative jobs are less susceptible to offshoring than managerial and white-collar positions, although there are some instances where some design work is also moving offshore. Notably, Sonoma County creative workers have seen their impact on the regional economy grow steadily, with the average annual wage now exceeding the national average.