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**Sonoma County  
Economic Development Board**

presents

**Financial  
and  
Creative Services**



**2004**

Prepared By

THE SONOMA COUNTY ECONOMIC DEVELOPMENT BOARD

Ben Stone, Director

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September 2004

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

Important information on financial services regarding current trends in local banking, insurance, and real estate markets is analyzed in the following pages.

Also discussed here is the “creative cluster”. This cluster is a group of occupations that bring innovative ideas, new technologies, and ultimately, new industries that help the local economy continue to flourish.

Highlights from the *2004 Financial and Creative Services Report* include:

- The County’s industrial production index increased dramatically during the first half of 2004, and now stands just below its peak in the fourth quarter of 2000.
- Local banking activity posted solid gains over the last year. In total, profits rose 17% in 2003 for the 11 commercial and savings banks headquartered in the County. Nevertheless, with rising interest rates and healthy competition among the 120 local bank branches, less-diversified banks will find it more difficult to increase profits.
- While both life and property/casualty insurers are quickly rebounding, employment in the local insurance industry continues to fall for the fourth consecutive year. This is due in part to direct sales via the Internet by insurance firms, and increasing outsourcing overseas.
- Local commercial real estate conditions are mixed, which is an improvement over last year.
- In the short-term, creative industries, dependent on investment spending and venture capital, will experience only moderate employment growth, while the long-term growth potential looks favorable in Sonoma County.

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



**With Acknowledgment and Appreciation to the Underwriters of the  
Economic Development Board Foundation Research Initiatives Program**  
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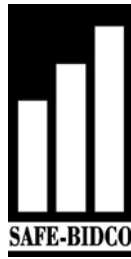
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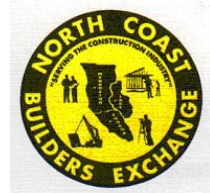
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**Recent Trends.** Unlike the majority of its Bay Area neighbors, financial services and creative clusters in Sonoma County continue to grow. Most segments of this broad industry are improving, despite the overall weak job growth within the county. Among the categories supporting the positive trend, architecture and engineering employment has experienced the largest gains. While commercial construction has languished, robust building during the 1990s helped develop a critical mass of workers, supporting the most consistent growth among the creative industries over the past five years.

Single-family home construction has remained remarkably robust in light of the generally slow economic conditions, thanks to extremely low mortgage interest rates. Also, low mortgage rates have spurred a spate of refinancing activity, putting cash back into homeowners' pockets. House-price appreciation is strong, with year-to-year percentage growth in the mid-teens, although this is below the statewide average.

Other segments applying upward pressure to financial and creative payrolls include legal occupations, as well as healthcare practitioners and technical occupations. While local high-tech companies, including Agilent Technologies and Advanced Fibre Communications, have trimmed payrolls, the resurgence of the IT replacement cycle has bolstered industrial activity in many high-tech companies. Economy.com estimates that the county's industrial production index increased dramatically during the first half of 2004 and now stands just below its peak in the fourth quarter of 2000. On the downside, employment in the local insurance industry continues to fall for the fourth consecutive year.

**Macro Drivers.** Economic growth nationwide has measurably slowed. Real GDP, which was expanding at a robust pace near 5% at the start of the year, weakened to only a 3% rate in the second quarter and does not appear to be faring much better so far in the third quarter. Job growth has been tepid during the three months ending in September. Businesses remain skittish, quickly reining in their hiring plans at any sign that business conditions are not meeting expectations.

The modest rise in mortgage rates from their spring low has crimped new borrowing. Mortgage refinancing activity, a popular way for households to raise cash, is currently a third of what it was at its

March 2004 peak. Now that monetary tightening has taken hold, home equity borrowing should decline markedly, as these loans are largely tied to the prime lending rate, which, in turn, is tied to Federal Reserve policy moves.

A growing dichotomy exists in the health of household balance sheets. While high-income households have weathered the weak job recovery fairly well, lower-income households have been much less fortunate. The financial stresses are evident from still near-record high credit problems. Personal bankruptcy filings, credit card delinquency rates, manufactured housing delinquency rates, direct auto loan delinquency rates, and mortgage foreclosure rates are all near record highs. As interest rates move higher, the risks to financial services will grow.

On the corporate side, business investment is still expanding. Since collapsing three years ago, the IT industry has staged a dramatic comeback. The replacement cycle gathered steam through last year, while consumer IT spending remained stalwart and global demand for IT started to pick up. Since the start of the year, large corporations have started to kick up spending, joining small and medium-sized businesses, which started to boost spending in 2003, putting the replacement cycle into high gear. All major segments of the IT industry—computer hardware, software, semiconductors, and even telecom equipment—are experiencing strong sales growth and healthy profitability. The only downside in recent months has been some deceleration in consumer demand, but business investment is more critical for high-tech firms in Sonoma County.

**Financial Services.** The banking industry is facing a more challenging environment, even as the economy improves. Until recently, low interest rates and booming mortgage activity supported strongly rising earnings for many banks. Now, in a rising interest rate environment, the broad diversification of large banking entities has paid dividends, as other business lines are picking up just as mortgage activity begins to wane. By contrast, less diversified banks will find it more difficult to increase profits as consumer lending slows, particularly given that business borrowing has yet to rebound in earnest. Indeed, the drive to diversify is

one factor that led to the recent agreement of acquisition of local National Bank of the Redwoods by Westamerica. The merger should be complete by early 2005.

Local banking activity has posted solid results over the past year. For example, Exchange Bank saw earnings rise 8% and loans jump 19% in the second quarter of 2004 compared to one year ago. Also posting strong gains among national banks with a large local presence was Wells Fargo, which saw net income rise 12% in the second quarter, thanks largely to strong balance sheet growth. Another regional, Washington Mutual (WAMU) posted significantly poorer results compared to one year ago. Indeed, the drop in mortgage income for WAMU forced cost-cutting measures across the board—local payrolls have been trimmed more than 50% over the past year. In total, profits rose 17% in 2003 for the 11 commercial and savings banks with headquarters in Sonoma County.

Loan demand remains firm, but the consumer segment could wane should the upward trajectory of interest rates accelerate. According to the FDIC, nearly 90% of local loans are tied to mortgages or construction activity. Moreover, healthy competition in Sonoma County, which boasts nearly 120 local bank branches, could drive tighter interest rate spreads and slimmer profits in the upcoming year. However, given the nascent rebound of the Bay Area economy and stabilizing local employment conditions, any drop in mortgage lending should at least be partially offset by a consummate increase in commercial activity, helping drive financial services growth in near term.

**Real Estate.** Local commercial real estate conditions are mixed, which is an improvement over one year ago. Telecom and other office-using employment layoffs during the area's recession left landlords with a glut of available space. Given the high cost of doing business in Sonoma County, which Economy.com estimates is roughly 18% higher than the national average, and the slow rebound in the rest of the Bay Area, attracting new business investment and expansions has proved difficult. Indeed, new commercial and industrial construction is stagnant and, given still high vacancy rates, will continue to languish well into 2005.

Vacancy rates, according to Keegan & Coppin, are trending higher for industrial

space, but are holding steady for retail space and edging down slowly for office space. Light and high-tech manufacturers slashed capacity during the nationwide downturn. While manufacturing activity has rebounded decidedly since the start of the year, companies are still wary of adding capacity.

Slow personal income growth has muted retail activity. Indications suggest retailers have put expansion plans on hold, with a vacancy rate fluctuating between 3% and 4% over the past year. On the upside, once job growth returns in earnest, retail activity should rebound sharply, allowing landlords to boost asking rents across most retail space.

Industrial activity has been hampered by continued cutbacks and consolidations at area businesses. An example is the closing of Agilent Technologies' facility in Rohnert Park and shifting some work to its Fountaingrove location, while transferring other work overseas.

Demand for office space is improving. The office availability rate of about 15% is down from the late 2000 peak of over 19%. But, given the plethora of business/office park space built during the 1990s, several quarters of robust hiring will be needed in order to significantly drive down excess office capacity.

**Insurance.** While both life and property/casualty insurers are in the midst of a sharp turnaround, the local industry continues its four-year-long employment decline. The property/casualty insurance industry reported a statutory rate of return of 9.4% in 2003, up from 1.1% a year before, according to the Insurance Services Office and the Property Casualty Insurers Association of America. The industry recorded its best performance in seven years and best underwriting performance in a quarter century. Property/casualty carriers benefited from a hard underwriting cycle, rising premiums and strong investment returns throughout 2003.

Rising equity prices buoyed the life insurance industry's investment portfolios since the second half of 2003. Despite rising interest rates, stagnant equity markets and a narrowing yield spread will challenge the investment climate for life insurers. The narrowing credit spreads will make it increasingly difficult for insurers to achieve higher yields without raising their exposure to credit, interest rates or liquidity risks. With corporate credit

conditions improving, investment-grade spreads are expected to further narrow. However, demand is returning—year to date, life insurance applications are down only 1% from last year, as compared to a decline of more than 4% for all of 2003.

Improved conditions in the industry have bolstered local stalwart State Farm, which added some local jobs in 2003. However, a majority of insurance businesses have suffered. Indicative of local trends, Regan Holding Corporation, parent company of a life insurance and annuities provider, shed roughly 5% of its workforce during the past year. Small businesses are experiencing a pricing squeeze as national insurance companies are offering more services and utilizing scale economies to offer extremely competitive pricing. Another long-term weight on local insurance providers and brokers is the increasing importance of direct sales by insurance firms. While brokers continue to provide a sizable amount of insurance business, more companies are offering direct service via internet sales and are passing the lower operational cost savings to the consumer. Stronger near-term economic conditions will buoy the local insurance industry, although risks to industry employment are weighted to the downside due not only to current sales trends but to the nascent acceleration of offshoring back-office operations.

**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 three 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, 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, 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 small presence in Sonoma. Once current lagging venture capital investment returns to traditional drivers, including electronics and software, creative employment should experience a marked improvement.

**Long-term Outlook.** The financial services industry in Sonoma County continues to have a positive long-term outlook. While interest rate hikes may cause some short-term fluctuations, Sonoma has many comparative advantages to draw more financial services business, including above average per capita income. Office and industrial real estate markets will remain moderately oversupplied for another year, placing some near-term constraints on asking lease rates. The county's ability to retain creative workers is supported by the area's very good quality of life, favorable climate, and its short distance from San Francisco.

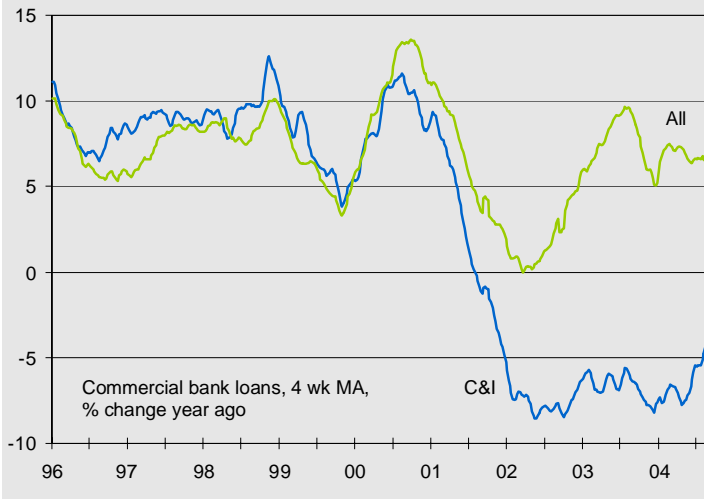
**Upside Risks.** Sonoma benefits greatly from spillover growth in other sections of the Bay Area. Should San Francisco, Oakland and San Jose rebound more quickly than anticipated, Sonoma should see an influx of financial services, real estate and creative employment. Additionally, as home to several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

**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 that help the economy to flourish.

*Daniel Jester  
September 2004*

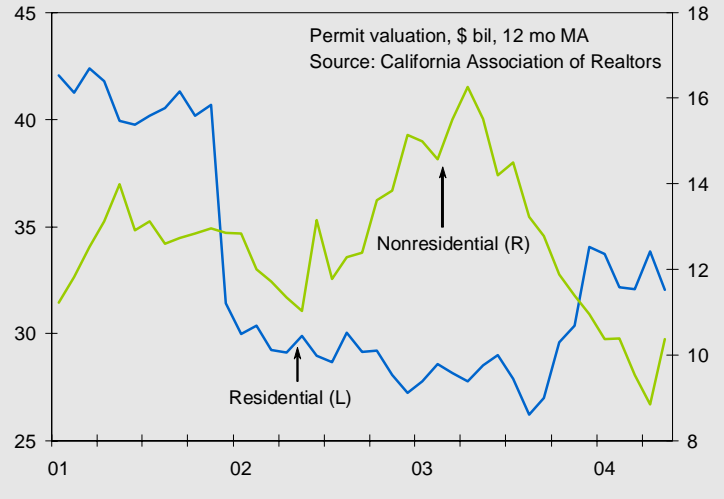
# Financial & Creative Services - Sonoma County

**U.S. Business Lending Still Moribund**



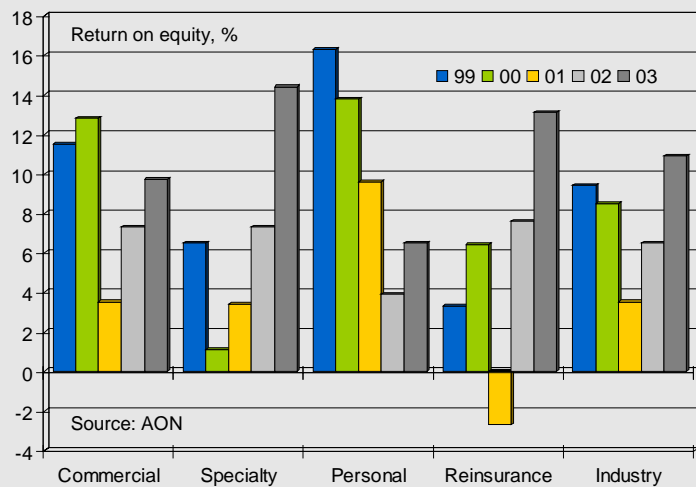
One key difference for banks in this current environment of rising interest rates is that commercial lending has not picked up to offset mortgage weakness. Among the reasons for the ongoing contraction in commercial lending is competition from bond financing, which has been brisk over the past two quarters. Flush corporate coffers are another reason, as corporations have not had to borrow to finance their spending. This should turn around as the economic recovery continues, but it remains a near-term constraint.

**Commercial Construction Lags**



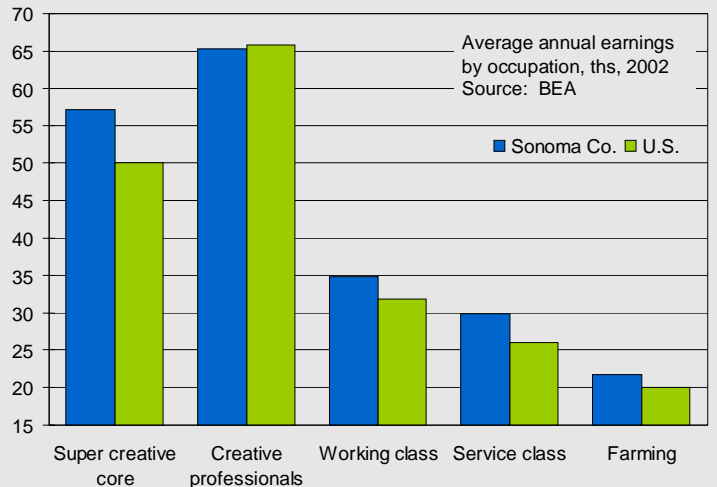
Weak nonresidential construction trends are hardly surprising. Poor job creation trends, both locally and for the Bay Area, have weighed on businesses. Moreover, the office park building boom of the late 1990s has helped create an oversupply of available space, negating the need for significant new construction. Real estate services will begin to strengthen, however, as the office and industrial vacancy rates begin to moderate later next year concurrently with improved labor markets.

**Profitability on the Rise in Every Segment of Insurance**



Every industry line is posting impressive year-on-year increases in return on equity. Strict underwriting standards, soaring bond values and a rebound in the stock market have led to improved underwriting performance and stronger investment returns. Record surpluses will also trigger increasing price competition and an easing in underwriting standards. While this year's severe hurricane season poses some downside risks to the industry nationally, expect insurance profits to remain strong in the near term.

**Occupation Income Clusters**



Average annual earnings for creative class workers is nearly double that of the working class, while almost triple that of other industries. Indeed, the creative class encompasses slightly less than 30% of the area's workforce but accounts for roughly half of all wages and salaries. While job creation in the creative industries has decelerated since 2000, the fact that the broad industry has weathered the harsh local recession without job losses suggests that creative employment will be an important catalyst for reviving economic growth in Sonoma County.